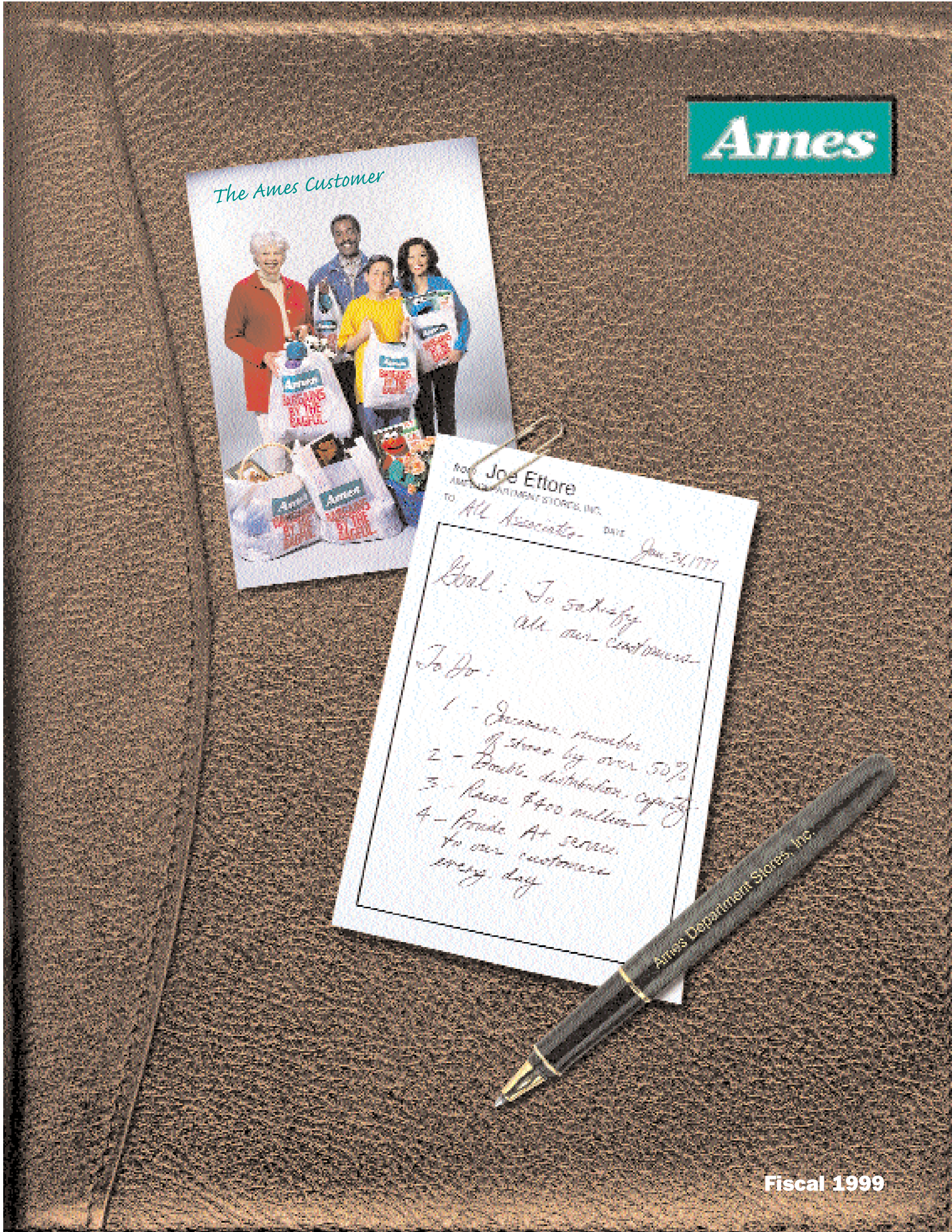

Ames
The Ames Customer
Joe Ettore
Ames Department Stores, Inc.
To All Associates
Goal: To satisfy all our customers
To Do:
1 - Increase number of stores by over 50%
2 - Double distribution capacity
3 - Raise $400 million
4 - Provide A+ service to our customers every day
Ames Department Stores, Inc.
Fiscal 1999

Company Mission

- *Provide quality products for family and home at discount prices*
- *Provide a convenient and efficient shopping experience*
- *Achieve a sustainable competitive advantage*
- *Build and sustain strong supplier partnerships*

Our 55 Gold® Club attracts many shoppers.

Company Profile

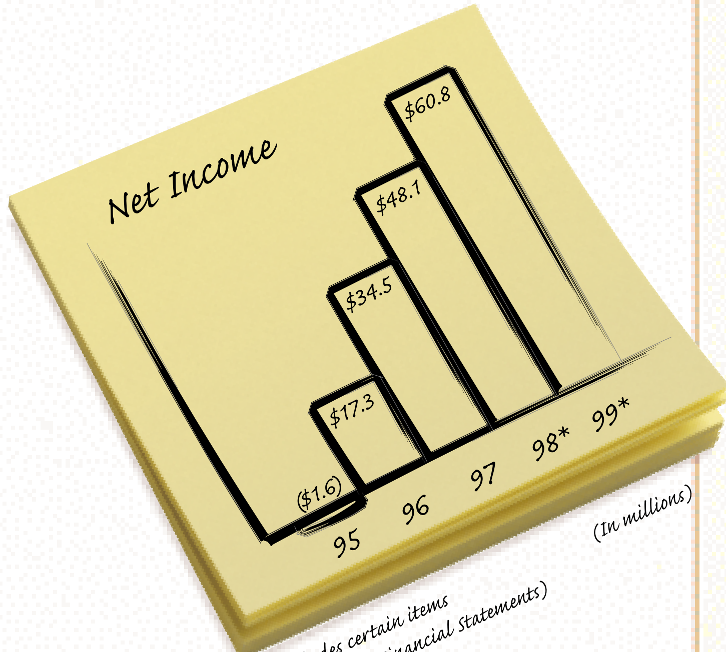
Ames Department Stores, Inc., the nation's largest regional discount retailer, excels at satisfying a large, but underserved, block of customers, providing them with quality, brand-name merchandise, low prices, friendly service and shopping convenience.

As a full-line discount retailer, Ames provides merchandise across a broad array of categories, including family apparel, housewares, domestics, electronics, ready-to-assemble and patio furniture, jewelry, crafts, pet supplies, health and beauty care items, stationery, sporting goods, toys, seasonal products and more.

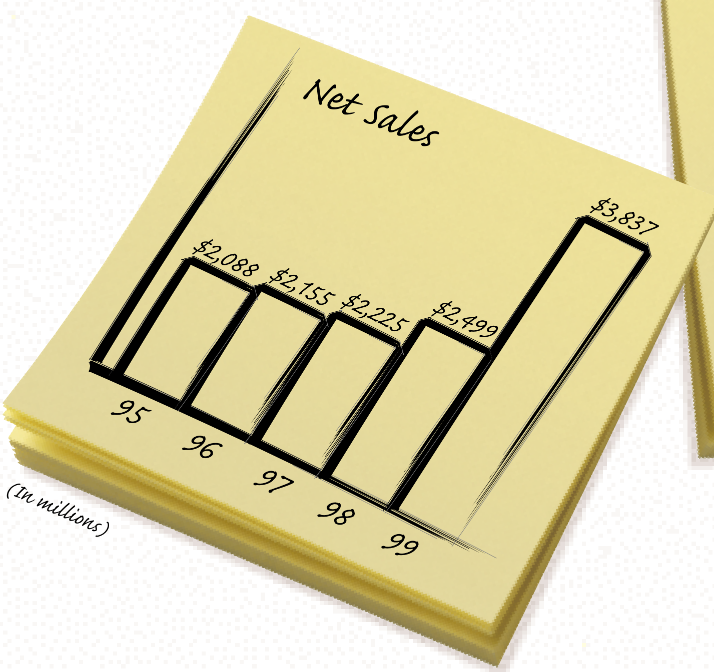
"The collective efforts of our management team and our associates are reflected in the 1999 results" — Joseph R. Ettore

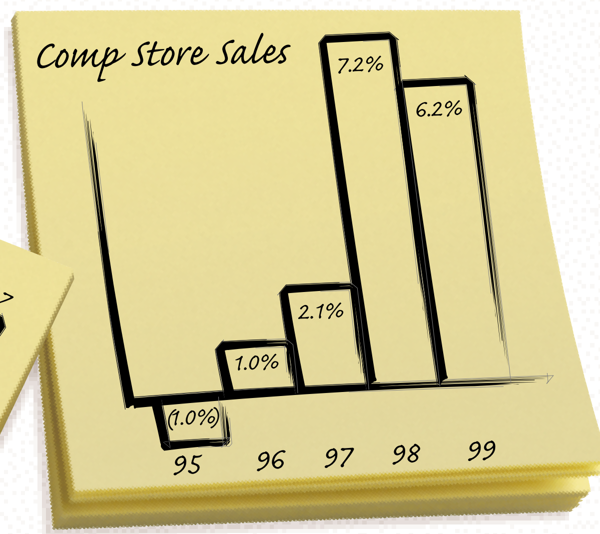
Financial Highlights

Left to right:
Denis T. Lemire, President and Chief Operating Officer;
Rolando de Aguiar, Senior Executive Vice President and
Joseph R. Ettore, Chairman and Chief Executive Officer.



* Excludes certain items
(see Note 3 to Financial Statements)





Plan

Letter to Our Shareholders

To Do

☑ *Plan strategy with Rolando and Denis*

Left to right: Joseph R. Ettore, Denis T. Lemire, and Rolando de Aguiar.

Dear Fellow Shareholders,

Several years ago we began a fundamental transformation of our Company. We reshaped the way we conduct our business by putting our highest priority on our customer and placing service at the core of everything we do. Once we had our marketing and merchandising formula working, it was time to grow and capitalize on our successes. Our accomplishments in 1999 played a critical role in this effort. Through the acquisition of the Hills Stores Company we expanded our geographic presence and brought the Ames format and merchandising strategy to millions of new customers.

We added 163 new Ames locations in 1999, including 151 former Hills stores and ten former Caldor sites. We also added two new distribution centers and subsequently reorganized traffic patterns. Our existing facilities can now accommodate a 25 percent increase in the number of our stores within our operating area with no need for extra capacity. And, most important, while we were remodeling, re-merchandising and reopening our 163 new stores—on target and on schedule—our management team never lost focus on our original 291 stores. We increased our business in our comparable store base by a robust 6.2 percent. We are very proud of these achievements.

We continue to focus on intelligent growth. This year we plan to add up to 25 new stores modeled on the proven Ames format for store design and merchandising. Our e-commerce strategy, through AmesPlace.com, Inc., will enable us to further serve the needs of our target customer with offerings that expand our selling space beyond the four walls of our stores. For example, through Amesmeds.com we have added a pharmacy to our website which meets the health-related needs of our customers, particularly our 55 Gold® Club members.

"We intend to run the business in ways that are beneficial to our customers, associates and vendors while increasing shareholder value and helping the communities we serve." — Joseph R. Ettore

There have been two important management changes over the last year. Denis Lemire's role was enhanced and earlier this year he was named President of the Company. Denis has been an important player on the Ames team and his contributions in merchandising and logistics have been instrumental to attaining our success. He retains the title of Chief Operating Officer.

Also earlier this year, Rolando de Aguiar was named President of our new e-commerce subsidiary, AmesPlace.com, Inc. Rolando was also promoted to the position of Senior Executive Vice President of Ames Department Stores, Inc. We have all benefited from his visionary leadership in formulating and executing key components of our growth strategy, including e-commerce.

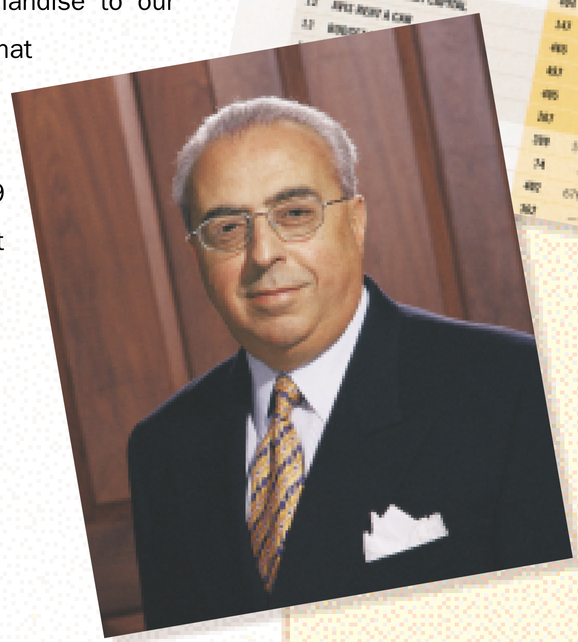
I would like to thank all of our associates, stockholders, vendor-partners and millions of customers who choose our stores every day. We are committed to providing the best service and merchandise to our customers. We intend to run the business in ways that are beneficial to our customers, associates and vendors while increasing shareholder value and helping the communities we serve. The annual report for 1999 reflects on the year and our many successes, and it provides a record of our achievements.

Sincerely,

Joseph R. Ettore
Chairman and
Chief Executive Officer

To Do

- [x] *Establish AmesPlace.com, Inc.*
- [x] *Make the Fortune 500*



Plan

February

FOCUS *"Everything we do is geared toward our customers who include time-starved working families and seniors."*

To Do

- ☑ Plan Hills merchandise liquidations, remodels, reopenings
- ☑ Open 151 Hills stores in three phases
  - Phase I April 22
  - Phase II July 22
  - Phase III Sept. 23
- ☑ Prepare for March Mania Promotion
- ☑ Consolidate overlapping markets

People who shop at Ames make up a clearly defined market of consumers whose demands for value are not fully met by other retailers, specifically: women between the ages of 18 and 55, working mothers, shoppers looking for larger sizes and people aged 55 and older. In general, our customer's family income is between $25,000 and $35,000 per year—and it often takes two people working to achieve that income. Other retailers underserve these time-starved and value-conscious consumers. We cater to these segments of the population in our merchandising strategy, store design and A+ customer service.

We target these consumers in a variety of ways. Every Sunday our customers "shop around the kitchen table" with our value-packed circulars. In order to provide extra value for our shoppers, we partner with our vendors to create great Extra Special Bargains. We provide unadvertised Special Buys, primarily in apparel, which offer great close-out values to our customers. In addition, our 55 Gold® Club members—shoppers aged 55 and older—enjoy a 10 percent discount on all merchandise, even sale items, every Tuesday. This program has made Tuesday the most popular shopping day of the week.

We listened to our customers when designing the format of our stores. They wanted stores of a manageable size. Ours average about 55,000 selling square feet—half the size of our competitor's stores. The smaller size of our company allows us to be more flexible in our merchandising mix and we can gear it to specific ethnic populations, or regional requirements. This focus brings even more value to our customers.

Our customers wanted the merchandise to be within easy reach and not piled to the rafters; and they wanted clear signage to make it easy to

March

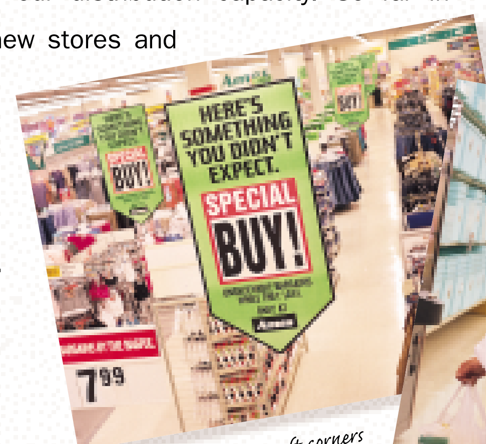
"This attention to the requirements of our target customers has allowed us to become the largest regional discount retailer in the United States."

locate merchandise. We have provided that. In addition, our wide main aisles, soft corners and racetrack design floor plan all combine to allow convenient access to all departments.

This attention to the requirements of our target customers has allowed us to become the largest regional discount retailer in the United States. In 1999, we increased our store base by over 50 percent. This growth, fueled by the acquisition of the Hills Stores Company, brought the Ames banner to many new markets and five new states. The Company operates 460 stores in nineteen states in the Northeast, Mid-Atlantic and Midwest, as well as the District of Columbia, and has announced plans for additional store openings, including the important Chicago market area.

In addition to the 151 former Hills stores converted during 1999 to new Ames stores, the Company opened twelve other stores, including ten former Caldor sites. Two distribution centers, one each from the Hills and Caldor purchases, doubled our distribution capacity. So far in 2000, we have opened seven new stores and have announced several more planned to open later this year.

We work to satisfy our customers. This is the reason for our success.



Our wide main aisles, soft corners and racetrack design floor plan all combine to allow convenient access to all departments.

55 Gold® Club member taking advantage of our Bargains by the Bagful®.

To Do

- ☑ *Purchase rights to eight Caldor stores plus Massachusetts distribution center*
- ☑ *Complete Hills merger*
- ☑ *Announce court approval of Caldor purchase*

March

EXECUTION

"By October we had added 163 stores and about 11 million square feet of selling space to our 291 store base."

To Do

- ☑ *April 22—Grand Opening of 51 stores (50 former Hills stores in Phase I & one store in Cinnaminson, NJ)*
- ☑ *Plan debt and equity offerings*
- ☑ *Finalize court approval of Caldor purchase*
- ☑ *Begin Phase II remodels*
- ☑ *Complete sale of Senior Notes*

The year 1999 was a banner year for Ames. It was a year in which we explosively grew the Company's revenue and store base while maintaining the profitable growth of our core stores. By October we had added 163 stores and about 11 million square feet of selling space to our 291 store base. We opened these stores on schedule and under budget, 51 stores on April 22, 54 stores on July 22 and 56 stores on September 23, plus two additional stores in October. We extended our reach both west and south by entering five new states. The Ames logo is now a familiar sight in nineteen states and the District of Columbia.

Soft corners enhance the shopping experience.

In 1999, we also doubled the capacity of our logistics network, expanding from two distribution centers to four. With this increased capacity we now have the ability to in-fill in our current markets and increase our store base by up to 25 percent without having to add new distribution facilities. At the same time, we realigned our distribution network and implemented new state-of-the-art systems.

In order to match this growth with appropriate funding, as well as to support our strategic plan, we successfully completed the sale of 5.1 million new shares of Ames stock. In addition, we issued $200 million in seven-year Senior Notes, raising a total of almost $400 million.

May

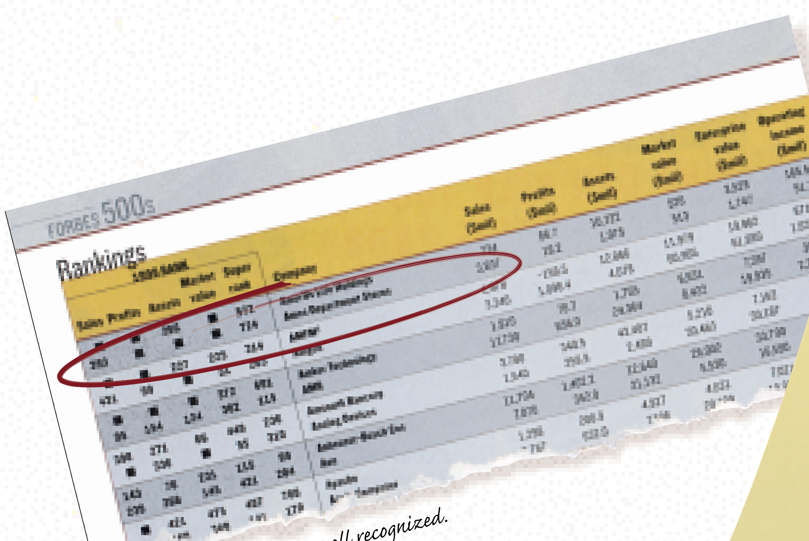
"Throughout this transition period, we stayed focused on running our original 291 stores."

By October of 1999, we had sold off the remaining Hills stores inventory, remodeled 151 Hills stores into the new Ames format, trained 15,000 new Ames associates, and reopened the sites as Ames stores. At the same time we were able to acquire, remodel and open twelve other stores, including ten former Caldor sites. The merchandise liquidation sales in the Hills stores were successfully handled by an outside agent, allowing us to concentrate on our core business.

The corporate headquarters of the former Hills Stores Company was closed and those activities were incorporated into the duties of our Rocky Hill headquarters staff.

Throughout this period of transition, we stayed focused on running our original 291 stores and maintaining our commitment to those stores' customers. The proof of that commitment is in the strong 6.2 percent comparable store sales number turned in for the year.

This successful strategy will continue to fuel our growth going forward.



Our achievements are well recognized.

To Do

- [x] *Price equity offering*
- [x] *Complete merchandise liquidation sales at Phase II stores*
- [x] *Begin preparation for July grand openings*

Eliminate $60 million of overhead

Increase same store sales by over 6%

June

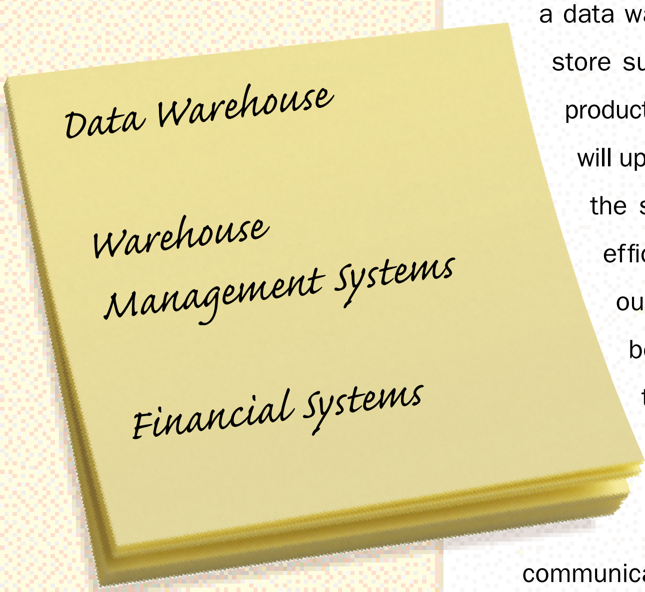
SYSTEMS

"While keeping costs down, we will be able to increase productivity and deliver consistent, reliable service to our customers."

To Do

- ☑ *Team with IBM for multi-year IT support*
- ☑ *Annual Meeting— Report 1998 as year of record operating results*

June



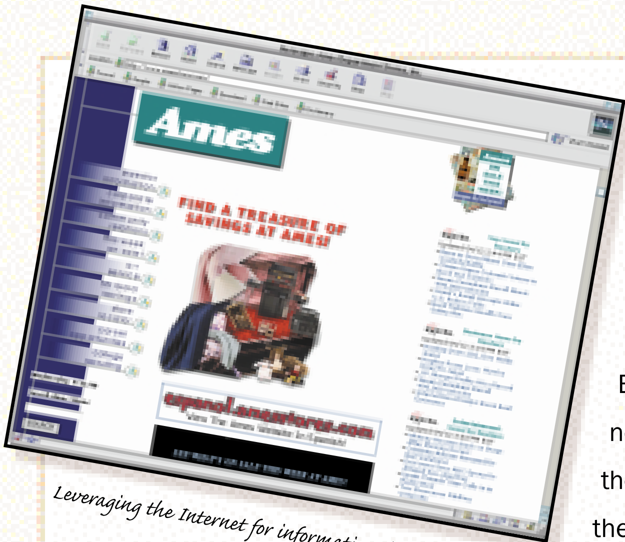
Increasing the selling square footage of our chain by over 75 percent within a nine-month period made it necessary to restructure our business systems. We turned to IBM Global Services to outsource our core information technology systems, including our data center, help desk, field service operations, communications, repair and maintenance. This arrangement allows us to leverage IBM's expertise so that as we continue to grow, our infrastructure grows with us. While keeping costs down, we will be able to increase productivity and deliver consistent, reliable service to our customers.

Next, we purchased state-of-the-art applications to increase productivity and facilitate decision-making in merchandising, logistics and finance. And, we installed software which would allow the various systems to share the same data base and to exchange information. We began with a data warehouse application which provides our merchandising and store support operations teams with tools to increase efficiency in product allocation and buying. New warehouse management systems will upgrade our distribution network to speed product flow throughout the supply chain—getting goods to our stores faster and more efficiently. And finally, our new financial system will streamline our financial processes and reduce paper-flow; and, it will allow both our retail store personnel and our field management team to use our Intranet to access financial reports.

The Company has also expanded its use of its Intranet by developing a Virtual Private Network (VPN) for secure communications. This network will also provide back-up for our existing store communications network and it will eliminate much of the paper-based policy manuals, procedures and forms used by the Company.

July

"Leveraging the Internet for information delivery and upgrading our store operations systems has put Ames at the forefront of technology."



Leveraging the Internet for information delivery.

Ames' redesigned website, AmesStores.com, features our weekly sales circulars and specialty circulars such as the Toy Book and Home Book. Our web visitors can now view products, such as their favorite toys, add them to their electronic shopping list and look for the latest money-saving e-coupons. We introduced espanol.AmesStores.com, the Spanish language version of our corporate website, becoming the first discount retailer to do so. Ames continues to explore e-commerce opportunities. We announced the formation of our new e-commerce subsidiary AmesPlace.com, Inc. which features items from our strategic e-commerce partners. We also announced our on line pharmacy, Amesmeds.com.

Finally, we improved store operating systems by replacing all mobile computing devices with radio frequency computer technology and installing new telephone systems.

Outsourcing our IT infrastructure, restructuring our core business systems, leveraging the Internet for information delivery and upgrading our store operations systems has put Ames at the forefront of technology in the discount retail environment. It helped us to consistently deliver A+ customer service during this period of rapid growth.

To Do

- ☑ *Begin remodel of Phase III stores*
- ☑ *July 22—Grand Opening of 54 former Hills stores as new Ames stores*
- ☑ *Begin preparation for the September grand openings*

COMMUNITY

"Communication, cooperation & common sense, A+ service & diversity—these are the principles that guide us in achieving our outstanding performance."

To Do

- ☑ Report record July comp sales and successful Phase II Grand Openings
- ☑ Strong back-to-school sales
- ☑ Exceed plan on Phase II Grand Openings

The Ames family includes a diverse group of over 35,000 associates, many of whom have been with us for many years. Our commitment to them is to provide meaningful career opportunities, growth and job satisfaction. Our associates are involved in their communities. They initiate charitable programs and support programs developed by the people in the neighborhoods we serve. Many of our community service ideas are first brought to our attention by customers or associates. Our commitment to the communities in which we do business is strong.

The Ames Stores Foundation, Inc., committed to fostering children's health, youth development, social awareness and community welfare, donated funds to Big Brother/Big Sister, the American Institute for Creative Education, the Horizon's initiative and a number of hospitals and universities near Ames stores. Ames has been involved for many years in health issues, particularly those involving children. Our Company donated thousands of toys for the December Gift-Wrap party for young patients undergoing treatment at the Connecticut Children's Medical Center and the Dana Farber Institute in Massachusetts.

We have teamed with our customers through a variety of in-store promotions to raise funds for the Muscular Dystrophy Association, the March of Dimes and the Cystic Fibrosis Foundation. Partnering with the Salvation Army, Ames associates and customers donated gifts and holiday dinners through the "Share Because You Care®" program—brightening the holiday season for many less fortunate people.

Along with the SHOPA Foundation (School and Home Office Products Association), Ames has made grants to public school teachers through the Kids in Need Teacher Grant Program. These awards are given to enable teachers to follow through on innovative classroom teaching ideas

"Diversity is all our similarities and differences that impact how we work together to achieve A+ performance and results."

that otherwise would not have sufficient funds. Ames also teamed up with the SHOPA Foundation to sponsor the Kids in Need Resource Center for underprivileged students in Washington, D.C. This center will benefit an estimated 3,500 children in area schools.

Through the Ames Charity Auction, Ames marked its fifth year of record-breaking financial support for the Hole in the Wall Gang Camp in Ashford, Connecticut. The camp offers a very special experience for children, aged seven to fifteen, with cancer or serious blood diseases.

Ames also rolled out to communities the Warm Up America! program, sponsored by the Craft Yarn Council of America. Volunteers crochet or knit squares that are then joined together to create afghan blankets. These blankets are donated to people in need at local homeless shelters, battered women's shelters, hospitals, AIDS facilities and others served by national non-profit organizations. Ames is committed to the communities in which we do business; it is our way of being a good neighbor.

Ames associates provide A+ customer service everyday.

Our Craft Department is a destination for many shoppers.

To Do

- ☑ *September 23 Announce Grand Opening of 56 new stores in eight states!*
  - *47 Phase III former Hills stores*
  - *9 former Caldor sites*
- ☑ *Become dominant discount retailer in Connecticut*
- ☑ *Successful Phase III Grand Openings*

October

PERFORMANCE

"Ames' strategy of growing revenues while limiting the growth of overhead costs is our formula for success."

To Do

- [x] Complete Data Center transition from Ames to IBM
- [x] Host Bikes-for-Kids community celebration

Bikes-for-Kids is a success with children.

Oct

Our expansion strategy is working. We added 163 stores and nearly 11 million square feet of selling space; we more than doubled our distribution capacity and added almost 15,000 new associates; and we did all this while maintaining our strong core business and A+ service. Clearly our plan works.

To support this fundamental growth of the Company, we set out to restructure our balance sheet through a combination of debt and equity offerings. By June 1999, we had successfully placed $200 million in seven-year Senior Notes and, in addition, we had concluded an offering of 5.1 million shares of Ames common stock. Within a few short months, we had raised almost $400 million.

Both our lenders and our rating agencies noted our excellent performance. Our bank group reduced the interest rate charged on our credit facility by 75 basis points and eliminated all financial covenants, unless our availability under our $650 million credit facility falls below a specified amount. In March 2000, Moody's Investors Service upgraded the rating on our seven-year Senior Notes adding another vote of confidence to our financial and operating performance in 1999.

While we grew our top line by over 60 percent, at the same time we were able to reduce the cost of goods sold as a percentage of sales by a full 50 basis points. This reflects our strong working partnership with our vendors, many of whom have been with us for many years. Also, on the expense side, Selling, General and Administrative expense—overhead—as a percent of net sales on our core business was reduced by 123 basis points.

November

"The results presented here validate that we have developed a formula for success in the discount retail market."

This clearly proves the point that our strategy of growing revenues while limiting the growth of overhead costs through a combination of improved processes, up-to-the-minute technology, outsourcing the IT infrastructure and a management team that recognizes and values economies of scale is a formula for success.

During 1999, a year of enormous growth and substantial change for the Company, we kept our eye on the ball. Although we added 163 new stores to our base of 291 original stores, we did not shift our focus far from our core stores. The proof of that is the 6.2 percent comparable store sales increase accomplished in 1999.

The results presented here validate that we have developed a formula for success in the discount retail market. We have met or exceeded all expectations for our business in 1999—the expectations of others as well as our own. Our customers recognize this time and time again and have shown with their purchasing votes that we meet a need that no other store meets.

Denis T. Lemire, President and Chief Operating Officer

Every Sunday our customers "shop around the kitchen table" with our value packed circulars.

To Do

- ☑ *Announce acquisition of six new stores*
- ☑ *Announce third quarter results which includes record 163 stores opened in 1999*
- ☑ *Announce opening of new Philadelphia store*
- ☑ *Roll out website redesign*

December

FUTURE *"The Company is well positioned to expand and be successful in the future."*

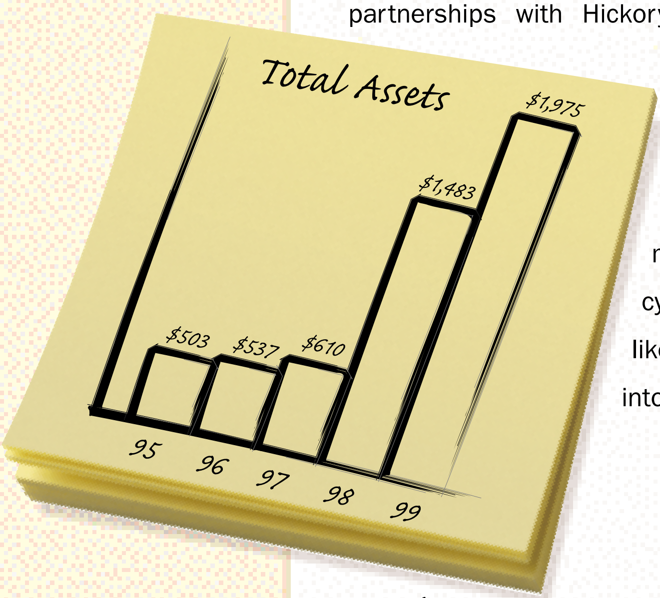
To Do

- ☑ *Partner with familymeds.com in e-commerce strategy*
- ☑ *Sponsor Dana Farber Gift Wrap Party*

The infrastructure is now in place. We have built a strong foundation for future growth. Our systems, logistics and personnel can support up to an additional 100 stores with little additional investment. Our plan is to add new stores opportunistically; we will open 25 new stores in 2000. We plan to remodel to our new format an additional 20 to 25 of our existing stores.

In 2000, we have already announced the opening of 15 stores in New York, Pennsylvania, Ohio, Delaware and Illinois, including seven Goldblatt's Department Stores in Chicago. This will mark Ames' debut in the Chicago market.

We will continue to develop our e-commerce strategy. Our website will be a lifestyle site aimed to serve the needs of our target customers and will offer many goods and services which we do not now offer in our stores, allowing us to extend beyond the four walls. We currently have partnerships with Hickory Farms, PC Flowers, Kitchen and Home, Improvements and Silhouettes. Coming soon will be our virtual pharmacy through Amesmeds.com offered in conjunction with *family*meds.com, Inc. We believe our brick and mortar stores give us an advantage over pure cyber-retailers since many of our customers may like to browse our circular on line and then come into our stores to shop.



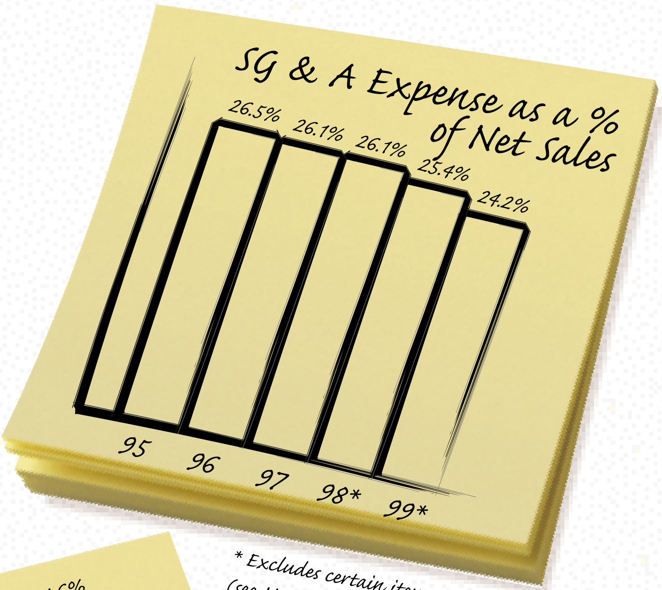
(In millions)

Dec

"We will continue to develop our e-commerce strategy."

January

We have proved this past year that the Ames formula is a formula for success; and it can be replicated because our customers—women, working families, shoppers age 55 and older—can be found in communities across the country. The Company is well positioned to expand and to be successful in the future by continuing to focus on creating value for our shareholders.



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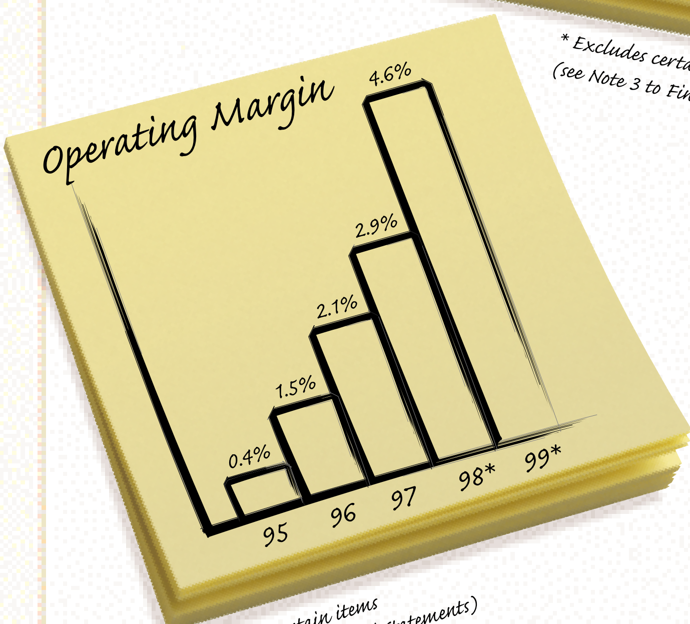

* Excludes certain items
(see Note 3 to Financial Statements)

To Do

- Achieve 75 basis point interest rate reduction on revolving credit facility
- Expand e-commerce strategy
- Plan on line virtual pharmacy
- Improve efficiencies at distribution centers
- Award teaching grants with SHOPA

Jan

AmesPlace.com, Inc. *"AmesPlace.com, Inc. positions Ames to take advantage of the exciting and rapidly developing growth opportunities available on the Internet."*

To Do

- Focus on core customer
- Leverage the power of the Internet
- Capitalize on business growth opportunity

Rolando de Aguiar
Senior Executive Vice President of Ames Department Stores, Inc.
President of AmesPlace.com, Inc.

AmesPlace.com

AmesPlace.com, Inc. is Ames' new exciting e-commerce subsidiary. Announced in April of fiscal 2000, this new company will focus on leveraging the power of the Internet in two primary areas: meeting the needs of Ames core customers and using the Internet to enhance business to business commerce.

Ames Customer and the Internet. AmesPlace.com, Inc. will focus the Internet towards the everyday needs of its core customer which today is underserved on the net. AmesPlace.com, Inc. will create Internet selling and informational services that will bring its customers value and convenience. An example of this is its recently announced Amesmeds.com pharmacy website which provides customers the ability to fill prescriptions, talk to a pharmacist, purchase health and beauty care items and get health-related information on line. The Ames core customer is projected to be the fastest growing segment on the Internet in the upcoming years and AmesPlace.com, Inc. will be positioned to capitalize on this rapidly developing business growth opportunity.

Business to Business Internet Commerce. The internet is creating new business opportunities and process efficiencies everyday that allow businesses to better share information and service their customers. AmesPlace.com will focus on just these types of initiatives. Whether it be bringing buyers and merchants together on line as it has through its alliance with Retailexchange.com or through its use of the Plumtree Internet Portal just announced, AmesPlace.com, Inc. will seek to leverage the Internet to streamline processes and improve information flow for decision making at Internet speeds.

AmesPlace.com, Inc. positions Ames to take advantage of the exciting and rapidly developing growth opportunities available on the Internet now and in the future.

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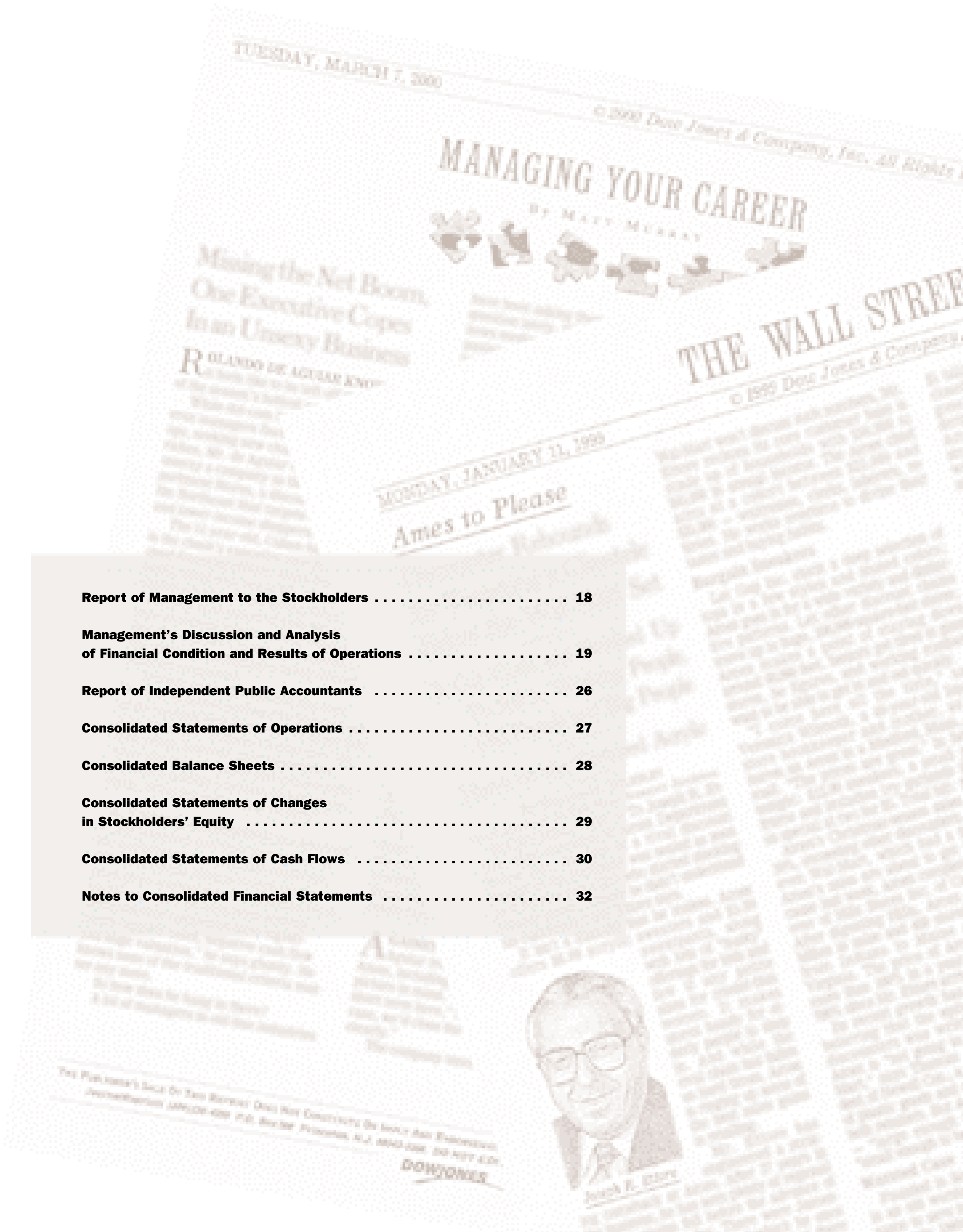

Report of Management to the Stockholders

The management of Ames is responsible for the integrity and objectivity of the financial and operating information contained in this annual report, including the consolidated financial statements covered by the Report of Independent Public Accountants. These statements were prepared in conformity with generally accepted accounting principles and include amounts that are based on the best estimates and judgments of management.

The Company has a system of internal accounting controls that provides management with reasonable assurance that transactions are recorded and executed in accordance with its authorizations, that assets are properly safeguarded and accounted for, and that financial records are maintained so as to permit preparation of financial statements in accordance with generally accepted accounting principles. This system includes written policies and procedures, an organizational structure that segregates duties, and a comprehensive program of periodic audits by the internal auditors. The Company also has instituted policies and guidelines that require employees to maintain the highest level of ethical standards.

In addition, the Audit Committee of the Board of Directors, consisting solely of outside directors, meets periodically with management, the internal auditors and the independent public accountants to review internal accounting controls, audit results and accounting principles and practices, and annually recommends to the Board of Directors the selection of independent public accountants.

Joseph R. Ettore
Chairman
and Chief Executive Officer

Rolando de Aguiar
Senior Executive Vice President and
Chief Financial Officer

Overview

Ames changed its fiscal year from the last Saturday in January to the Saturday nearest January 31, effective with the fiscal year ended January 30, 1999, which we refer to as "Fiscal 1998." We made this change so that our fiscal year would coincide with the fiscal year of most other publicly-held retailers. Our fiscal year ended January 29, 2000, which we refer to as "Fiscal 1999," and Fiscal 1998 consisted of 52 weeks. Our fiscal year ended January 31, 1998, which we refer to as "Fiscal 1997," consisted of 53 weeks.

You should read the discussion that follows in conjunction with the Consolidated Financial Statements and related Notes appearing elsewhere in this Annual Report.

Results of Operations

Fiscal 1999 Compared to Fiscal 1998

During Fiscal 1999, the inventory in the 155 former Hills stores was liquidated, and 151 stores were remodeled and opened as Ames stores. This process was completed in September 1999. During the liquidation period, professional liquidators operated the former Hills stores under an agency agreement with Ames. Under the agreement, Ames received a minimum guaranteed amount of 40% of the initial ticketed retail price of the inventory sold and had the potential to receive a greater return if the sale proceeds exceeded a specified percentage of retail value. For financial reporting purposes in the charts that follow, Hills net sales represent the actual sale proceeds from the merchandise liquidation sales, its cost of merchandise sold represents the cost of merchandise sold as adjusted for the guaranteed return amount, and its selling, general and administrative expenses include the portion of those proceeds that were to be paid to the liquidators.

Upon completion of the liquidation and remodeling, the Hills stores were reopened and participated in grand opening promotions. Consequently, we incurred higher than normal preopening and promotion expenses in Fiscal 1999.

Because of the liquidation activity, the remodeling activity and the large volume of grand openings with their associated expenses, the consolidated operating results are not representative of those of a retailer operating in the ordinary course of business and are not directly comparable to previously published Ames results exclusive of Hills.

	Fiscal 1998	Fiscal 1999				
(In millions)	**Ames**	**Ames**	**Hills**	**Other**	**Layaway Adjustment**	**Total**
Total net sales	$2,386.5	$3,465.6	$375.6	$ –	$ (4.4)	$3,836.8
Leased department and other income	29.2	39.1	2.6	–	–	41.7
Total revenue	2,415.7	3,504.7	378.2	–	(4.4)	3,878.5
Costs and expenses:						
Cost of merchandise sold	1,711.3	2,467.8	251.2	–	(3.6)	2,715.4
Selling, general and administrative expense	606.9	838.7	153.0	76.5	–	1,068.2
Depreciation and amortization expense, net	11.3	49.1	11.1	5.3	–	65.5
Interest and debt expense, net	11.4	54.1	4.1	2.6	–	60.8
Income (loss) before income taxes	74.8	95.0	(41.2)	(84.4)	(0.8)	(31.4)
Income tax (provision) benefit	(26.7)	(34.2)	14.8	68.7	0.3	49.6
Income (loss) before cumulative effect adj.	48.1	60.8	(26.4)	(15.7)	(0.5)	18.2
Cumulative effect adjustment, net of tax	–	–	–	–	(1.1)	(1.1)
Net income (loss)	$ 48.1	$ 60.8	$ (26.4)	$(15.7)	$(1.6)	$17.1

The Ames column for Fiscal 1998 represents the results of the Ames store base excluding (a) the results of operations for the Hills stores acquired as of December 31, 1998 and (b) other costs and charges related to the Hills acquisition. Including the effect of the Hills stores and other costs related to the acquisition, we recorded consolidated net income of $33.8 million for the fifty-two weeks ended January 30, 1999.

The "Ames" column for Fiscal 1999 represents (a) the results of the Ames store base, (b) the results of the former Hills stores after their conversion to Ames stores and (c) certain expenses associated with the acquisition of Hills, including the interest expense on the acquired Hills senior notes and a prorata share of the amortization of the goodwill recorded in connection with the acquisition.

The "Hills" column for Fiscal 1999 represents (a) the results of operations for the Hills stores during the period that these stores were operated pursuant to an agency agreement, including depreciation and interest expense directly associated with such stores and (b) Hills corporate overhead expenses, principally the Canton, Massachusetts corporate facility (see Note 2 to the accompanying Consolidated Financial Statements for further discussion of the agency agreement accounting).

The "Other" column for Fiscal 1999 represents expenses incurred during the period of remodeling the Hills stores (i.e., pre-opening expenses incurred during the conversion or "dark" period) as well as certain other expenses and tax benefits.

The "Layaway Adjustment" column represents the impact of the change in the method of accounting for layaway sales. We adopted the change in accounting for layaway sales in the fourth quarter of Fiscal 1999 in consideration of Staff Accounting Bulletin No. 101 "Revenue Recognition" issued by the staff of the Securities and Exchange Commission in December 1999.

The liquidation and remodeling activity in the former Hills stores distorts any direct comparison of the principal components of Ames consolidated results for Fiscal 1999 and Fiscal 1998 and prior years. Accordingly, in the discussion that follows, Ames net sales, gross margin, selling, general and administrative expenses, and its leased department and other income for Fiscal 1999 and Fiscal 1998 will be compared excluding the pre-conversion Hills results and other charges. The comparison of depreciation and amortization expense as well as interest and debt expense will be on a consolidated basis.

Net sales increased to $3.5 billion in Fiscal 1999 from $2.4 billion in Fiscal 1998 due primarily to the sales contribution of the former Hills stores after conversion to the Ames format and 6.2% growth in same store sales. We experienced strong increases in our Ladies Sportswear, Toys and Home Entertainment departments.

Gross margin increased $322.6 million in Fiscal 1999 compared to Fiscal 1998. The increase is primarily attributable to the inclusion of the former Hills stores and an increase in the gross margin rate from 28.3% to 28.8% in Fiscal 1999. The gross margin rate in Fiscal 1999 benefited from lower markdowns.

Selling, general and administrative expenses increased $231.8 million in Fiscal 1999 compared to Fiscal 1998, primarily as a result of the addition of the former Hills stores. Selling, general and administrative expenses decreased as a percentage of net sales from 25.4% in Fiscal 1998 to 24.2% in Fiscal 1999. The decrease resulted from the 6.2% comparable store sales gain and improved efficiencies of scale due to the Hills acquisition.

Leased department and other income increased $9.9 million in Fiscal 1999 from Fiscal 1998. A substantial portion of the increase resulted from additional leased sales originating in the former Hills stores, as well as an increase in layaway fees, also originating in the former Hills stores.

Depreciation and amortization expense increased by $51.0 million in Fiscal 1999 compared to Fiscal 1998. The increase resulted from the additional depreciation and amortization of the former Hills fixed assets and beneficial lease rights and the amortization of goodwill. The beneficial lease rights and goodwill related to the Hills acquisition are being amortized on a straight-line basis over the term of the underlying lease (25 years on average) for the lease rights and 25 years for goodwill. The amortization of the excess of our revalued net assets over equity under fresh start reporting remained the same in Fiscal 1999 as in Fiscal 1998. We are amortizing this amount over a ten-year period which will conclude in January 2003.

Net interest expense increased $45.6 million in Fiscal 1999 compared to Fiscal 1998. The increase was primarily attributable to interest expense incurred for our 10% senior notes, the Hills capital lease and financing obligations and a higher level of borrowings under our bank credit agreement. During the year, we completed the issuance of our 10% senior notes to support the

conversion of the former Hills stores. See the liquidity and capital resources section of this document for further discussion of these events.

We recorded a consolidated income tax benefit of $49.6 million in Fiscal 1999 compared to an $18.8 million provision in Fiscal 1998. This Fiscal 1999 benefit primarily represents the reduction of a valuation allowance of $38.1 million previously recorded against certain deferred tax assets, which reflects our expectation of using the net operating loss carry-forwards and other deferred tax assets in the foreseeable future. See Note 8 to the Consolidated Financial Statements for additional information.

Subsequent to the date of these financial statements, we announced the purchase of the leases to seven Goldblatt's stores in the Chicago area, marking our entry into this market.

Fiscal 1998 Compared to Fiscal 1997

On December 31, 1998, we acquired approximately 81.3% of the outstanding voting stock of Hills Stores Company. Accordingly, the operations of Hills and its subsidiaries during the month of January 1999 are included in our consolidated results of operations for Fiscal 1998. Immediately following our acquisition of Hills, we began implementing a series of initiatives to prepare for the conversion of 151 Hills stores into Ames stores and the permanent closure of the four remaining Hills stores. These initiatives included the termination of most of Hills' corporate and administrative operations and personnel, the announced closure of seven Ames stores that we considered to be directly competitive with acquired Hills stores or under-performing and the engagement of two experienced liquidation firms, Gordon Brothers Retail Partners LLC and The Nassi Group LLC, to operate the Hills stores until their closure and to liquidate Hills' merchandise inventories.

Under our agreement with Gordon Brothers LLC and The Nassi Group LLC, we were entitled to retain from the proceeds of the liquidation sales, as a minimum guaranteed amount, 40% of the initial ticketed retail price of the inventory sold, irrespective of the actual price at which it sold. The remaining sale proceeds, net of the expenses of operating the stores, were payable to the liquidators as compensation for their services, subject to additional allocations to Ames to the extent that proceeds exceeded specified targets. For financial reporting purposes, Hills' net sales during the month of January represent the actual sale proceeds from merchandise liquidation sales, its cost of merchandise sold represents the guaranteed minimum amount that Ames is entitled to retain, and its selling, general and administrative expenses include the portion of those proceeds that were paid to the liquidators.

Because of the unique nature of our contractual arrangements with Gordon Brothers LLC and The Nassi Group LLC, as well as the fact that the Hills stores were in the process of liquidation, Hills' results for the month of January 1999 are not representative of those of a retailer operating in the ordinary course of business and are not directly comparable to Ames' results exclusive of Hills. The acquisition of Hills also resulted in various costs and charges during the month of January 1999 that impacted Ames' consolidated results. These other costs and charges consisted principally of costs associated with terminating contracts that became obsolete with the acquisition of Hills, the write-off of deferred financing costs related to a prior credit facility, interest expense for borrowings incurred to finance the acquisition and a one-time charge for the announced closing of seven Ames stores. The table on the following page illustrates the separate contribution of Ames' full year of operations and Hills' one month of operations to various components of the consolidated results of operations for Fiscal 1998, as well as the impact on the consolidated results of the other costs and charges described above.

Management's Discussion and Analysis of Financial Condition and Results of Operations

	Fiscal 1997	Fiscal 1998			
(In millions)	**Ames**	**Ames**	**Hills**	**Other**	**Total**
Total net sales	$2,225.5	$2,386.5	$112.1	$ –	$2,498.6
Leased department and other income	25.0	29.2	1.0	–	30.2
Total revenue	2,250.5	2,415.7	113.1	–	2,528.8
Costs and expenses:					
Cost of merchandise sold	1,596.0	1,711.3	66.3	–	1,777.6
Selling, general and administrative expenses	581.7	606.9	52.0	1.7	660.6
Depreciation and amortization expense, net	6.6	11.3	3.2	–	14.5
Interest and debt expense, net	11.6	11.4	2.0	1.9	15.3
Store closing charge	1.0	–	–	8.2	8.2
Income (loss) before income taxes	53.6	74.8	(10.4)	(11.8)	52.6
Income tax (provision) benefit	(19.1)	(26.7)	3.7	4.2	(18.8)
Net income (loss)	$ 34.5	$ 48.1	$ (6.7)	$(7.6)	$ 33.8

The circumstances under which Hills' operations have been conducted since December 31, 1998 and the accounting treatment accorded those operations as a consequence of the agreement with Gordon Brothers and The Nassi Group distort any direct comparison of the principal components of Ames' consolidated results for Fiscal 1998 and Fiscal 1997. Accordingly, in the discussion that follows, Ames' net sales, gross margin, selling, general and administrative expenses, and its leased department and other income for Fiscal 1998 are presented and compared exclusive of the Hills results. The impact of the Hills acquisition is included in the comparison of depreciation and amortization expense and interest and debt expense.

Ames' net sales increased 7.3% to $2.40 billion in Fiscal 1998 from $2.23 billion in Fiscal 1997, due primarily to 7.2% growth in same-store sales. Ames experienced particularly strong improvements in sales of domestics, toys, ready to assemble furniture, and women's sportswear. In comparing results for the two fiscal years, you should bear in mind that net sales in Fiscal 1997 were favorably affected by the inclusion of a full or nearly full year of operations of two stores that were closed in the beginning of Fiscal 1998 and by the fact that Fiscal 1997 included one additional week of operations.

Ames gross margin increased $45.7 million in Fiscal 1998 compared to Fiscal 1997, but remained unchanged as a percentage of net sales at 28.2%. The gross margin rate in Fiscal 1998 benefited from a higher average markup on sales, which was partially offset by higher markdowns.

Ames' selling, general and administrative expenses increased $25.3 million in Fiscal 1998, but decreased as a percentage of net sales from 26.0% in Fiscal 1997 to 25.3% in Fiscal 1998. The percentage decrease was primarily attributable to a reduction in store related expenses and advertising expense, partially offset by an increase in health and medical costs.

Ames' leased department and other income increased $4.1 million, or 16.3%, in Fiscal 1998 compared to Fiscal 1997. The increase was due primarily to the leased shoe department, layaway and vending income, as well as the receipt of funds previously held in trust.

Ames' depreciation and amortization expense increased by $4.6 million, or 69.1%, in Fiscal 1998 compared to Fiscal 1997. The increase related primarily to new point-of-sale systems and store automation equipment acquired under certain capital leases. The Hills acquisition added a further $3.2 million of depreciation and amortization expense associated with the additional depreciation and amortization of its fixed assets and beneficial lease rights and the amortization of goodwill relating to the excess of the Hills acquisition cost over the value of the acquired assets. We are amortizing the beneficial lease rights using the straight-line method over the terms of the related leases (which average approximately 25 years) and amortizing the Hills goodwill over 25 years on a straight-line basis. The amortization of the excess of our revalued net assets over equity under fresh-start reporting remained the same in Fiscal 1998 as in Fiscal 1997. We are amortizing this amount over a ten-year period that will conclude in January 2003.

The Hills acquisition resulted in a 31.5%, or $3.7 million, increase in consolidated interest expense, net of interest income, in Fiscal 1998. Debt and capital lease obligations of Hills accounted for $1.9 million of the increase. Another $1.4 million of the increase was attributable to the non-cash write-off

of deferred financing costs under Ames' prior credit facility. The balance was attributable to borrowings under our bank credit agreement to finance costs of the acquisition.

In the fourth quarter of Fiscal 1998, we recorded charges of $8.2 million in connection with the announced closing of seven Ames stores that were scheduled to close in Fiscal 1999. Principal components of these charges are lease costs and the write-down of fixed assets. We also planned for the closing of four of the acquired Hills stores and, pursuant to the purchase method of accounting, provided for these closings in the valuation of the acquired Hills assets. In the fourth quarter of Fiscal 1997, we recorded charges of $1.6 million in connection with the closing of two stores, of which $1.0 million was classified as a store closing charge and $0.6 million was recorded as part of the cost of merchandise sold.

We recorded an income tax provision of $18.8 million in Fiscal 1998, of which approximately $0.5 million was paid in cash. In Fiscal 1997, we recorded an income tax provision of $19.1 million, of which approximately $0.3 million was paid in cash. See Note 8 of the Notes to Consolidated Financial Statements.

Liquidity and Capital Resources

Ames' principal sources of liquidity are its bank credit agreement, cash from operations and cash on hand. Our current bank credit agreement provides for a revolving credit facility of up to $650 million expiring June 30, 2002. Borrowings under the agreement are secured by substantially all of our assets and we are required to meet certain financial covenants if our availability under the credit agreement falls below specified levels. Our peak borrowing level in Fiscal 1999 under the agreement was $414.9 million.

On April 27, 1999, we completed the sale of $200 million of Ames 10% senior notes. The net proceeds from the sale of the Ames senior notes, approximately $193.4 million, were used to reduce outstanding borrowings under our bank credit facility. The Ames senior notes pay interest semi-annually in April and October and mature in April 2006.

On May 24, 1999, we completed the public offering of 5.1 million shares of Common Stock at a price of $38.75 per share. The proceeds of approximately $187.3 million, net of underwriting discounts, were used to reduce our borrowings under the bank credit facility and for general corporate purposes.

Our cash position decreased $5.1 million during Fiscal 1999. The decrease was due primarily to $209.6 million of capital expenditures, inventory investment of $181.5 million and $25.8 million in debt and capital lease payments, partially offset by $129.6 million of borrowings under our bank credit agreement, $193.4 million from the issuance of the Ames senior notes and the net amount of $187.3 million from the issuance of common stock. Our cash position decreased by $22.1 million during Fiscal 1998. This decrease was due primarily to $103.9 million paid out in the acquisition of Hills (net of cash acquired), $51.6 million of capital expenditures and $16.3 million in debt and capital lease payments partially offset by $111.6 million in cash from operations and $44.9 million of borrowings under our bank credit facility.

Merchandise inventories increased $210.1 million in Fiscal 1999 due to the addition of twelve new stores, in addition to fully stocking the former Hills stores and recording the inventory in the converted Hills stores at cost in Fiscal 1999 as compared to liquidation value in Fiscal 1998. In Fiscal 1998, the Hills inventories were valued at approximately 40% of the ticketed retail price of the merchandise, representing the minimum amount we were entitled to retain out of the proceeds from the liquidation of the merchandise. Merchandise inventories increased by $197.7 million in Fiscal 1998 due to planned increases and the inclusion of $169.1 million of Hills merchandise inventories.

Net fixed assets increased by $130.1 million during Fiscal 1999 due to $209.6 million in capital expenditures, primarily relating to remodeling the former Hills stores ($189.1 million), and opening twelve other stores. These additions were partially offset by the writedown of $29.8 million in fixed assets acquired from Hills and depreciation expense of $61.1 million recorded during Fiscal 1999. Net fixed assets increased by $288.3 million during Fiscal 1998 due to the inclusion of $230.9 million in net fixed assets of Hills and $77.5 million of capital expenditures, including $25.9 million in new point-of-sale equipment under capital leases. The Hills net fixed assets were adjusted to their estimated fair value as of the acquisition date.

Beneficial lease rights represent the excess of the fair market value of the acquired Hills leases over contract value of those leases. We are amortizing this amount over the terms of the related leases using the straight-line method.

Goodwill decreased $169.4 million as a result of the final determination of the fair market value of the assets and liabilities acquired with the Hills stores and a full year of amortization expense, which approximated $8.3 million. The primary changes were the reduction of $114.1 million deferred tax asset valuation allowance (see Note 8 to the Consolidated Financial Statements), a reduction in accrued liabilities and reserves of $48.3 million as these liabilities were no longer deemed to be required and the increase of $28.3 million to inventory values. When the Hills inventory was liquidated, proceeds generated were greater than anticipated. These changes were partially offset by an additional $29.8 million write-down of fixed assets (primarily fixtures) acquired from Hills to recognize their deemed fair value. Goodwill is being amortized over 25 years using the straight-line method.

Accounts payable increased $20.8 million due to an increase in merchandise receipts in January 2000 over January 1999. Accounts payable increased $173.6 million during Fiscal 1998 due to improved payment terms, and the inclusion of Hills accounts payable of $127.8 million as of January 30, 1999.

Long-term debt as of January 29, 2000 consisted of borrowings under our bank credit agreement of $174.5 million, $47.2 million of Hills senior notes and $200 million of Ames senior notes. Subsequent to fiscal year end we announced that we had amended our $650 million credit facility. The amended agreement provides Ames with a reduction in the interest rate charged and enhanced flexibility as to the usage of the funds available under the credit facility.

Capital lease and financing obligations decreased by $7.2 million during Fiscal 1999 as payments on capital lease obligations exceeded new capital leases.

We have not paid any cash dividends during the past four fiscal years. The payment of cash dividends is restricted under the terms of our bank credit agreement.

Capital Expenditures

Capital expenditures for Fiscal 1999 were $209.6 million and included, among other items, the opening of twelve new stores, the remodeling of the former Hills stores and the upgrading of selected management information systems, including the completion of our chain-wide installation of new point-of-sale information equipment and related software in our stores.

Capital expenditures for Fiscal 1998 were $77.5 million and included the opening of six new stores, the remodeling of twenty-two stores, and the upgrading of certain management information systems.

Capital expenditures are expected to be approximately $140.0 million for Fiscal 2000. These capital expenditures will be comprised of remodeling and conversion of the former Goldblatt's stores, 25 new stores, and maintenance of our existing stores. We expect to finance these expenditures through cash flow from operations and borrowings under our bank credit agreement. Land, buildings and improvements are financed principally through long-term leases.

Seasonality

Our business is seasonal in nature, with a large portion of our net sales occurring in the second half of our fiscal year as a result of the back-to-school and Christmas shopping seasons. Net sales are highest in the last fiscal quarter (37% of our annual net sales in Fiscal 1999). The demand for working capital is heaviest in May, and from August through November, when sufficient merchandise must be purchased for the spring, back-to-school and Christmas seasons, respectively.

Legal

We are party to various claims and legal proceedings on a wide range of matters that arise in the ordinary course of business. Ames intends to defend these issues vigorously and believes that the final outcome of the various proceedings will not have a material adverse impact on its consolidated financial position or results of operations.

Impact of Year 2000

Ames completed its remediation and testing of systems for Year 2000 vulnerabilities in late 1999. No disruptions in mission critical information technology and non-information technology systems were experienced during the 1999/2000 changeover and we believe those systems successfully responded to the Year 2000 date change. Ames expensed approximately $2.9 million during 1999 in connection with its Year 2000 remediation efforts. Our total cost for our Year 2000 effort was approximately $6.7 million. We are not aware of any material problems resulting from Year 2000 issues, either with our products and internal systems, or with the products and services of third parties. We will continue to monitor mission critical computer applications and those of our suppliers and

vendors throughout the Year 2000 to ensure that any latent Year 2000 matters that may arise are addressed promptly.

Accounting Policy Matters

In June 1998 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair market value. The statement also requires that changes in derivatives fair market value be recognized currently in earnings unless specific hedge accounting criteria are met. SFAS No. 133 is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000, with early adoption at the beginning of any fiscal quarter being permitted. We are currently analyzing the impact of this new pronouncement on our financial position and result of operations.

In December 1999 the Securities and Exchange Commission issued Staff Accounting Bulletin "SAB" No. 101 "Revenue Recognition." Under SAB No. 101, we are required to change the method in which we account for layaway sales. Prior to the adoption of SAB No. 101, we recorded layaway sales when customers placed merchandise on layaway. The pronouncement mandates that layaway sales be recorded when the customer takes possession of the merchandise. We adopted SAB No. 101 during the fourth quarter of Fiscal 1999, effective as of the beginning of Fiscal 1999. The impact of adopting this pronouncement resulted in a cumulative effect adjustment to current earnings for approximately $1.1 million, net of $0.6 million tax benefit.

We adopted Statement of Position ("SOP") 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" effective the beginning of Fiscal 1999. SOP 98-1 was effective for fiscal years beginning after December 15, 1998. This SOP requires companies to capitalize certain costs incurred in connection with an internal-use software project. Prior to Fiscal 1999, we expensed the costs of developing or obtaining internal use software as incurred. The amount of internal use software cost capitalized in Fiscal 1999 was approximately $1.6 million.

Forward-Looking Statements

The statements contained or incorporated by reference in this Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Annual Report that are not historical facts are "forward-looking statements," as that term is defined in the Private Securities Litigation Reform Act of 1995. Those statements include all discussions of strategy as well as statements that contain such forward-looking expressions as "believes," "estimates," "intends," "may," "will," "should," or "anticipates" or the negative thereof. In addition, from time to time, our representatives or we have made or may make forward-looking statements orally or in writing. Furthermore, forward-looking statements may be included in our filings with the Securities and Exchange Commission as well as in the press releases or oral presentations made by or with the approval of one of our authorized executive officers.

We caution you to bear in mind that forward-looking statements, by their very nature, involve assumptions and expectations and are subject to risks and uncertainties. Although we believe that the assumptions and expectations reflected in the forward-looking statements contained herein are reasonable, no assurance can be given that those assumptions or expectations will prove to have been correct. Important factors that could cause actual results to differ materially from our expectations include, but are not limited to, the following:

- Deteriorating economic conditions in the United States, particularly in the regions in which our stores are located;
- Decreased consumer spending, particularly among those consumers who comprise our primary customer base;
- Increased competition from other discount retailers, including the major national chains, as well as from merchandise offerings on the Internet;
- Severe adverse weather conditions during the winter months, particularly during the peak Christmas holiday shopping season.

All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these factors and the cautionary statements contained herein.

Report of Independent Public Accountants

To the Stockholders and Board of Directors of Ames Department Stores, Inc.:

We have audited the accompanying consolidated balance sheets of Ames Department Stores, Inc. (a Delaware corporation) and subsidiaries as of January 29, 2000 and January 30, 1999, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the fifty-two weeks ended January 29, 2000, and the fifty-two weeks ended January 30, 1999 and the fifty-three weeks ended January 31, 1998. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Ames Department Stores, Inc. and subsidiaries as of January 29, 2000 and January 30, 1999, and the results of their operations and their cash flows for the fifty-two weeks ended January 29, 2000, and the fifty-two weeks ended January 30, 1999 and the fifty-three weeks ended January 31, 1998 in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP

New York, New York
March 13, 2000

Consolidated Statements of Operations

(In thousands, except per share amounts)	52 Weeks Ended January 29, 2000	52 Weeks Ended January 30, 1999	53 Weeks Ended January 31, 1998
Ames net sales	$3,459,737	$2,386,522	$2,225,456
Hills net sales	377,117	112,126	—
Total net sales	3,836,854	2,498,648	2,225,456
Leased department and other income	41,690	30,164	25,069
Total revenue	3,878,544	2,528,812	2,250,525
Costs and expenses:			
Ames cost of merchandise sold	2,463,301	1,711,337	1,595,974
Hills cost of merchandise sold	252,085	66,324	–
Ames selling, general and administrative expenses	915,213	608,653	581,659
Hills operating expenses and agency fees	152,962	51,940	–
Depreciation and amortization expense, net	65,495	14,478	6,659
Interest and debt expense, net	60,843	15,253	11,600
Store closing charge	–	8,222	1,000
Income (loss) before income taxes	(31,355)	52,605	53,633
Income tax benefit (provision)	49,589	(18,775)	(19,087)
Income before Cumulative Effect of Accounting Change	18,234	33,830	34,546
Cumulative Effect of Accounting Change, net of tax of $614	(1,107)	–	–
Net income	$ 17,127	$ 33,830	$ 34,546
Basic net income per common share:			
Before Cumulative Effect of Accounting Change	$ 0.66	$ 1.47	$ 1.59
Cumulative Effect of Accounting Change, net of tax	(0.04)	–	–
Net income	$ 0.62	$ 1.47	$ 1.59
Weighted average common shares	27,517	23,010	21,723
Diluted net income per common share:			
Before Cumulative Effect of Accounting Change	$ 0.66	$ 1.40	$ 1.46
Cumulative Effect of Accounting Change, net of tax	(0.04)	–	–
Net income	$ 0.62	$ 1.40	$ 1.46
Weighted average common and common equivalent shares	27,658	24,216	23,649

(The accompanying notes are an integral part of these consolidated financial statements.)

Consolidated Balance Sheets

(In thousands, except per share amounts)	January 29, 2000	January 30, 1999
ASSETS		
Current Assets:		
Cash and short-term investments	$ 30,612	$ 35,744
Receivables:		
Trade	7,426	13,315
Other	17,876	16,929
Total receivables	25,302	30,244
Merchandise inventories	831,387	621,509
Prepaid expenses and other current assets	36,772	16,075
Deferred taxes, net	28,854	–
Total current assets	952,927	703,572
Fixed Assets:		
Land and buildings	25,388	22,319
Property under capital leases	176,107	159,654
Fixtures and equipment	310,750	179,766
Leasehold improvements	117,734	76,095
	629,979	437,834
Less – Accumulated depreciation and amortization	(128,229)	(66,205)
Net fixed assets	501,750	371,629
Other assets and deferred charges	57,256	16,447
Deferred taxes, net	346,055	102,406
Beneficial lease rights, net	56,280	58,885
Goodwill, net	61,026	230,454
Total Assets	$1,975,294	$1,483,393
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable:		
Trade	$ 325,356	$ 313,280
Other	96,224	87,477
Total accounts payable	421,580	400,757
Current portion of capital lease and financing obligations	22,086	17,799
Self-insurance reserves	29,827	29,115
Accrued compensation	42,095	64,840
Accrued expenses	91,015	160,449
Store closing reserves	55,468	59,768
Total current liabilities	662,071	732,728
Long-term debt	421,769	95,810
Capital lease and financing obligations	180,404	191,904
Other long-term liabilities	57,916	114,922
Excess of revalued net assets over equity under fresh-start reporting	17,868	24,021
Commitments and contingencies		
Stockholders' Equity:		
Preferred stock (3,000,000 shares authorized; no shares issued or outstanding at January 29, 2000 and January 30, 1999, respectively; par value per share $.01)	–	–
Common stock (40,000,000 shares authorized; 29,233,650 and 23,921,545 shares outstanding at January 29, 2000 and January 30, 1999, respectively; par value per share $.01)	293	239
Additional paid-in capital	530,744	236,667
Retained earnings	105,143	88,016
Treasury stock (79,495 shares, at cost)	(914)	(914)
Total Stockholders' Equity	635,266	324,008
Total Liabilities and Stockholders' Equity	$1,975,294	$1,483,393

(The accompanying notes are an integral part of these consolidated financial statements.)

Consolidated Statements of Changes in Stockholders' Equity

(In thousands)	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Treasury Stock Shares	Treasury Stock Amount	Total Equity
Balance, January 25, 1997	–	$ –	20,474	$205	$ 88,341	$ 19,640	–	$ –	$108,186
Exercise of warrants			1,260	13	1,386				1,399
Exercise of stock options, net			772	7	3,074				3,081
Utilization of tax attributes					26,170				26,170
Net income						34,546			34,546
Balance, January 31, 1998	–	$ –	22,506	$225	$118,971	$ 54,186	–	$ –	$173,382
Exercise of warrants			824	8	1,387				1,395
Exercise of stock options, net			331	3	1,106				1,109
Issuance of common stock pursuant to executive employment agreement			70	1	1,640				1,641
Issuance of restricted common stock, net			190	2					2
Vesting of restricted common stock					788				788
Utilization of tax attributes					112,775				112,775
Acquisition of treasury shares							(79)	($914)	(914)
Net Income						33,830			33,830
Balance, January 30, 1999	–	$ –	23,921	$239	$236,667	$ 88,016	(79)	($914)	$324,008
Exercise of stock options, net			170	2	1,073				1,075
Issuance of common stock pursuant to the equity offering			5,100	51	187,211				187,262
Issuance of restricted common stock, net			30	1					1
Issuance of common stock to Board of Directors			12		367				367
Utilization of tax attributes					105,426				105,426
Net Income						17,127			17,127
Balance, January 29, 2000	–	$ –	29,233	$293	$530,744	$105,143	(79)	($914)	$635,266

(The accompanying notes are an integral part of these consolidated financial statements.)

Consolidated Statements of Cash Flows

(In thousands)	52 Weeks Ended January 29, 2000	52 Weeks Ended January 30, 1999	53 Weeks Ended January 31, 1998
Cash flows from operating activities:			
Net income	$17,127	$33,830	$34,546
Cumulative Effect of Accounting Change	1,107	–	–
Net income before cumulative effect adjustment	18,234	33,830	34,546
Expenses not requiring the outlay of cash:			
Income tax (benefit) provision	(49,589)	18,275	18,764
Depreciation and amortization of fixed and other assets	65,495	15,487	6,884
Amortization of debt discounts and deferred financing costs	4,880	2,787	861
Other, net	(1,841)	(3,514)	1,834
Cash provided by operations before changes in working capital and store closing activities	37,179	66,865	62,889
Changes in working capital:			
Decrease (increase) in receivables	4,942	(6,787)	149
(Increase) decrease in merchandise inventories	(181,546)	12,259	(32,760)
(Increase) decrease in prepaid expenses and other current assets	(20,697)	(2,962)	109
Increase in accounts payable	20,823	12,233	34,239
(Decrease) increase in accrued expenses and other current liabilities	(91,467)	24,302	5,033
Changes due to store closing activities:			
Payments of store closing costs	(9,470)	(2,547)	(13,907)
Store closing charge	–	8,222	1,000
Net cash (used for) provided by operating activities	(240,236)	111,585	56,752
Cash flows from investing activities:			
Acquisition costs, net of cash acquired	–	(103,857)	–
Proceeds from the disposition of properties	–	–	1,900
Purchases of fixed assets	(209,606)	(51,602)	(32,875)
Purchases of leases	(38,835)	–	(2,801)
Net cash used for investing activities	(248,441)	(155,459)	(33,776)
Cash flows from financing activities:			
Borrowings under the revolver credit facilities, net	129,609	44,935	–
Payments on debt and capital lease obligations	(22,191)	(16,262)	(15,747)
Repurchase of Hills senior notes	(4,636)	–	–
Proceeds from the issuance of senior notes	200,000	–	–
Proceeds from the issuance of common stock, net	187,262	–	–
Deferred financing costs	(7,939)	(10,902)	–
Proceeds from the exercise of options and warrants	1,440	4,933	4,480
Purchase of treasury stock	–	(914)	–
Net cash provided by (used for) financing activities	483,545	21,790	(11,267)
(Decrease) increase in cash and short-term investments	(5,132)	(22,084)	11,709
Cash and short-term investments, beginning of period	35,744	57,828	46,119
Cash and short-term investments, end of period	$30,612	$35,744	$57,828

(The accompanying notes are an integral part of these consolidated financial statements.)

1. Summary of Significant Accounting Policies

(a) Nature of operations

Ames Department Stores, Inc. (a Delaware corporation) and its subsidiaries (collectively, "Ames" or the "Company") are retail merchandisers. As of March 31, 2000, Ames operated 460 discount department stores in 19 states in the Northeast, Midwest and Mid-Atlantic regions, as well as the District of Columbia. The stores are located in rural communities, small cities and urban areas, and the suburbs of larger metropolitan areas.

(b) Basis of presentation and principles of consolidation

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The consolidated financial statements include the accounts of Ames and its subsidiaries, all of which are wholly-owned. All intercompany accounts and transactions have been eliminated.

Certain prior year items have been reclassified to conform to the current year presentation.

(c) Fiscal year

The Company changed its fiscal year from the last Saturday in January to the Saturday nearest January 31, effective with the fiscal year ended January 30, 1999. This change was made so that the Company's fiscal year would coincide with the fiscal year of most other publicly-held retailers. There was no impact on the current year period as a result of this change. The fiscal year ended January 29, 2000 ("Fiscal 1999" or "1999") included 52 weeks. The fiscal year ended January 30, 1999 ("Fiscal 1998" or "1998") included 52 weeks. The fiscal year ended January 31, 1998 ("Fiscal 1997" or "1997") included 53 weeks.

(d) Cash and short-term investments

Ames considers all highly liquid investments with an original maturity of three months or less when purchased to be cash and short-term investments. As of January 29, 2000 and January 30, 1999 there were no short-term investments.

(e) Inventory valuation

Inventories are valued at the lower of cost, using the first-in, first-out (FIFO) method, or market and include the capitalization of transportation and distribution center costs.

(f) Internal use Software

The Company adopted Statement of Position ("SOP") 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" effective the beginning of Fiscal 1999. SOP 98-1 was effective for fiscal years beginning after December 15, 1998. This SOP requires companies to capitalize certain costs incurred in connection with an internal-use software project. Prior to Fiscal 1999, the Company expensed the costs of developing or obtaining internal use software as incurred. The amount of internal use software cost capitalized in 1999 was approximately $1.6 million.

(g) Fixed assets

Land and buildings, fixtures and equipment, and leasehold improvements are recorded at cost. Major replacements and betterments are capitalized. Maintenance and repairs are charged to earnings as incurred. The cost of assets sold or retired and the related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal, with the resulting gain or loss included in earnings.

(h) Intangible assets

Beneficial lease rights represent the excess of fair market value over contract value of certain of the leases acquired in the Hills Acquisition (as defined in Note 2 below). Goodwill represents the excess of cost over the fair value of net tangible assets acquired at the date of acquisition. Accumulated amortization of goodwill and beneficial lease rights at January 29, 2000 was $9.0 million and $2.8 million respectively. See Note 2 for further explanation.

(i) Depreciation and amortization

Buildings and fixtures and equipment are recorded at cost and are depreciated on a straight-line basis over their estimated useful lives. Buildings are depreciated over 31.5 years, furniture and fixtures over ten (10) years, equipment over seven (7) years, motor vehicles over five (5) years, and computer software and hardware over three (3) to five (5) years. Property under capital leases and leasehold improvements are depreciated over the shorter of their estimated useful lives or their related lease terms.

Beneficial lease rights are being amortized over the terms of the related leases (which average approximately 25 years). Goodwill is being amortized over a 25-year period.

The excess of revalued net assets over equity under fresh-start reporting is being amortized over a 10-year period. The amount recorded as a credit to depreciation and amortization was $6.2 million in each of Fiscal 1999, Fiscal 1998 and Fiscal 1997.

The unfavorable lease liability is being amortized on a straight-line basis over the applicable lease terms (see Note 5).

Depreciation and amortization includes adjustments recorded pursuant to the application of Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The Company did not record an impairment loss during Fiscal 1999 and 1998. During Fiscal 1997 the Company recorded an impairment loss of $1.2 million.

(j) Deferred charges

Pursuant to SOP 98-5, "Reporting on the Costs of Start-Up Activities," expenses related to new store openings are expensed when incurred.

Debt transaction costs and related issue expenses are deferred and amortized over the term of the associated debt. Lease acquisition and related costs are deferred and amortized over the term of the lease.

(k) Income taxes

Ames files a consolidated federal income tax return. In December 1992, Ames adopted Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109") under fresh-start reporting. Under this method, any deferred income taxes recorded are provided for at currently effected statutory rates on the differences in the basis of assets and liabilities for tax and financial reporting purposes. If recorded, deferred income taxes are classified in the balance sheet as current or non-current based upon the expected future period in which such deferred income taxes are anticipated to reverse.

(l) Self-insurance reserves

The Company is self-insured for workers' compensation, general liability, property and casualty, and accident and health insurance claims, subject to certain limitations. The Company has insurance coverage for losses that may occur above certain levels. The Company determines its liability for claims based on the circumstances of each individual claim and estimates its liability for claims incurred but not yet reported based on historical experience. As of January 29, 2000 and January 30, 1999, Ames had established self-insurance reserves of $66.8 million and $66.3 million, respectively. The long-term portion of these reserves is classified as part of other long-term liabilities in the Consolidated Balance Sheets. These reserves are subject to changes in estimates as claims are settled or continue to remain outstanding.

(m) Leased department and other income

Ames has an agreement with an independent contractor that allows the independent contractor to operate shoe departments within the Ames stores. Ames receives a percentage of the sales under the agreement.

(n) Earnings per common share

In February 1997 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS No. 128"). Under SFAS No. 128, the presentation of Primary and Fully Diluted Earnings per Share was replaced by Basic and Diluted Earnings per Share. The Company adopted the provisions of SFAS No. 128 effective January 31, 1998, and has restated all periods presented.

Net income per common share for each of Fiscal 1999, 1998 and 1997 was determined by using the weighted average number of common and common equivalent shares outstanding during that fiscal year. Common equivalent shares represented the assumed exercise of the Company's outstanding Series B and Series C Warrants and stock options.

(o) Stock-based compensation

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," ("SFAS No. 123") encourages, but does not require companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("APB Opinion No. 25") and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of grant over the exercise price of the options.

(p) Revenue recognition

The Company recognizes revenue when its customer takes possession of merchandise. An appropriate reserve for estimated sales returns is recorded and is reflected in accrued expenses in the accompanying Consolidated Balance Sheets.

In December 1999 the Securities and Exchange Commission issued Staff Accounting Bulletin "SAB" No. 101 "Revenue Recognition." Under SAB No. 101, the Company is required to change the method in which it accounts for layaway sales. Prior to the adoption of SAB No. 101, the Company recorded layaway sales when customers placed merchandise on layaway. SAB No. 101 mandates that layaway sales be recorded when the customer takes possession of the merchandise. The Company adopted SAB No. 101 during the fourth quarter of Fiscal 1999, effective as of the beginning of Fiscal 1999. The impact of adopting this SAB resulted in a cumulative effect adjustment to current earnings for approximately $1.1 million, net of $0.6 million tax benefit.

(q) Advertising expense

The Company participates in cooperative advertising programs supported by our vendors. Advertising costs are expensed as incurred and are presented net of any funds received from vendors for these programs. The Company expensed $123.9 million, $79.7 million and $79.3 million for Fiscal 1999, Fiscal 1998 and Fiscal 1997, respectively.

2. Acquisition and Agency Agreement

Acquisition of Hills Stores Company

On December 31, 1998, HSC Acquisition Corp. ("HSC"), a wholly owned subsidiary of the Company, acquired in excess of 80% of the outstanding voting stock of Hills Stores Company ("Hills") and approximately 74% of the outstanding Hills 12.5% senior notes. In April 1999, Hills was merged with and into Ames Department Stores, Inc. Total cash consideration for the acquisition of Hills was approximately $129 million.

The acquisition was recorded under the purchase method of accounting and, accordingly, the results of operations of Hills since the acquisition date are included in the accompanying consolidated financial statements. The aggregate purchase price of $129 million has been allocated to assets acquired and liabilities assumed based on a determination of respective fair market values at the date of acquisition. The fair value of tangible assets acquired and liabilities assumed were $568 million each. The balance of the purchase price, $129 million, was recorded as two components: an excess of cost over net assets acquired (goodwill) of $70 million, which is being amortized over 25 years on a straight-line basis, and beneficial lease rights of $59 million, which is being amortized over the life of the respective leases (which averaged approximately 25 years).

Initially, the estimate of the fair market value of assets acquired and liabilities assumed had resulted in a valuation of goodwill of approximately $231 million. The final determination of the fair market values decreased goodwill by $161 million. The primary changes were a reduction of $114.1 million in deferred tax asset valuation allowances (see Note 8 to the Consolidated Financial Statements), a reduction in accrued liabilities and reserves of $48.3 million as these liabilities were no longer deemed to be required; and an increase of $28.3 million to inventory values as a result of the higher than expected proceeds upon liquidation of the Hills inventory. These changes were partially offset by an additional $29.8 million write-down of fixed assets (primarily fixtures) acquired from Hills to recognize their deemed fair market value. Since the date of acquisition, goodwill has also been reduced by $9.0 million of amortization expense.

At the time of the acquisition, Hills operated 155 discount department stores. During 1999, the Company remodeled and converted 151 of the Hills stores to Ames stores. The four remaining Hills stores along with seven other Ames stores were closed because they were in locations that were either competitive with, or were under-performing, other Hills or Ames stores. The remodeling and conversion process was conducted in three stages, each stage involving approximately one third of the Hills stores. The first stage was completed in April 1999; the second was completed in July 1999; and the third stage was completed in September 1999.

Agency Agreement Overview

Concurrent with the Hills Acquisition, the Company entered into a transition and agency agreement (the "Agency Agreement") with Gordon Brothers Retail Partners, LLC and The Nassi Group, LLC, (collectively the "Agent"), which provided that the Agent shall serve for a period of time to operate all of the acquired Hills stores and to conduct inventory liquidation sales at each of those stores prior to its scheduled remodeling or final closure. Accordingly, the Agent managed the sale of the inventory acquired in the Hills Acquisition as well as certain other inventory identified in the Agency Agreement.

The Agency Agreement entitled the Company to receive out of the sale proceeds a minimum amount equal to 40% of the initial retail value or ticketed selling price of the merchandise (the "Guaranteed Return"). The Company was also entitled to an additional payment if the proceeds of the sale exceeded a target percentage of the initial retail value. Finally, the Agency Agreement entitled the Company to reimbursement of certain store operating expenses (e.g., payroll, rent, advertising, etc.) out of the sale proceeds during the agency period.

Agency Agreement Accounting

As discussed earlier, the results of operations of Hills since the date of the acquisition have been included in the accompanying consolidated financial statements. For the month of January 1999, and for the duration of the Agency Agreement, the following accounting treatment was applied to recognize the results of the Hills stores prior to their conversion to Ames stores during Fiscal 1999: Hills net sales were recorded as "Hills Net Sales" and represent net sales achieved by the Hills stores prior to their conversion to Ames stores. "Hills Cost of Merchandise Sold" represents the cost of merchandise sold in connection with the above referenced sales as adjusted for the Guaranteed Return amount mentioned above. "Hills Operating Expenses and Agency Fees" includes the following: the associated store expenses incurred while operating the Hills stores prior to their conversion to Ames stores, which were reimbursable to the Company out of the proceeds of Hills merchandise sales per the Agency Agreement; the Agency Fee (defined below) due to the Agent for the period presented; and other expenses (e.g., non-store payroll, non-store rent, etc.) associated with supporting the Hills stores prior to their conversion to Ames stores, which were not reimbursable under the Agency Agreement.

The Agent was paid a fee (the "Agency Fee") for its services pursuant to the Agency Agreement. The Agency Fee was an amount equal to the proceeds from the sales of Hills merchandise less a deduction for the reimbursement of store operating expenses, the Guaranteed Return and an allocation to the Company based on sale proceeds in excess of specified levels. The Agency Fee recorded during Fiscal 1999 and 1998 was $41.7 million and $21.7 million, respectively.

The inventory liquidation sales at the Hills stores were completed during the quarter ended July 31, 1999. Proceeds from the sales during the entire agency period exceeded the targeted percentage referenced above. The Company shared in the excess and thereby realized in excess of the Guaranteed Return for the acquired Hills inventory.

Acquisition of Caldor Sites

During March 1999, the Company entered into two agreements with Caldor Corporation to purchase seven of its stores in Connecticut, two stores in Massachusetts and a 649,000 square foot distribution center in Westfield, Massachusetts, for a total cash purchase price of $42.8 million. Under the terms of the agreements, the Company assumed Caldor's leases for the nine stores and the distribution center and acquired all of the store fixtures in eight of the stores and all racking, sorting systems and materials handling equipment in the distribution center. During March and April 1999, the United States Bankruptcy Court for the Southern District of New York approved the Company's right to purchase the leases for the stores and the distribution center. All of the transactions subsequently closed.

A component of the $42.8 million purchase price was recorded as fixtures and equipment in the Westfield distribution center. The balance of the purchase price was recorded under other assets and deferred charges, and is being amortized over the remaining term of the leases.

3. Supplemental Information

The following table illustrates the separate contribution to the Company's consolidated results of operations for Fiscal 1999 of (i) the operations of Ames stores during that year, (ii) the operation of the former Hills stores during that year and various other costs and charges discussed below:

(In millions, except per share amounts)	**Fiscal 1999**				
	Ames	**Hills**	**Other**	**Layaway Adjustment**	**Total**
Net sales	$3,465.6	$375.6	$ –	$ (4.4)	$ 3,836.8
Leased department and other income	39.1	2.6	–	–	41.7
Total revenue	3,504.7	378.2	–	(4.4)	3,878.5
Costs and expenses:					
Cost of merchandise sold	2,467.8	251.2	–	(3.6)	2,715.4
Selling, general and administrative expenses	838.7	153.0	76.5	–	1,068.2
Depreciation and amortization expense, net	49.1	11.1	5.3	–	65.5
Interest and debt expense, net	54.1	4.1	2.6	–	60.8
Income (loss) before income taxes and cumulative effect	95.0	(41.2)	(84.4)	(0.8)	(31.4)
Income tax (provision) benefit	(34.2)	14.8	68.7	0.3	49.6
Income (loss) before Cumulative Effect	60.8	(26.4)	(15.7)	(0.5)	18.2
Cumulative Effect of Accounting Change, net of tax	–	–	–	(1.1)	(1.1)
Net income (loss)	$ 60.8	$ (26.4)	$(15.7)	$ (1.6)	$ 17.1
Diluted net income (loss) per common share	$ 2.20	$ (0.95)	$(0.57)	$(0.06)	$ 0.62
Weighted average common and common equivalent shares	27.7	27.7	27.7	27.7	27.7

The "Ames" column represents (a) the results of the Ames store base, (b) the results of the former Hills stores after their conversion to Ames stores, and (c) certain expenses associated with the acquisition of Hills, including the interest expense on the acquired Hills senior notes and a pro-rata share of the amortization of the goodwill recorded in connection with the acquisition.

The "Hills" column represents (a) the results of operations for the Hills stores during the period that these stores were operated pursuant to the Agency Agreement including depreciation and interest expense directly associated with such stores and (b) Hills corporate overhead expenses, principally the Canton, Massachusetts facility. The cost of merchandise for Hills represents the merchandise sold during this liquidation period adjusted for the Guaranteed Return (see Note 2). The selling, general and administrative expenses for former Hills include the reimbursable store operating expenses of $84.8 million; the Agency Fee of $41.7 million; and other non-reimbursable expenses of $26.5 million. The depreciation and amortization expense for Hills includes the depreciation and amortization of the revalued fixed assets; the amortization of the beneficial lease rights and the goodwill recorded in the Hills Acquisition. The interest expense reflects interest on the debt, capital lease and financing obligations assumed in the Hills Acquisition.

The "Other" column represents expenses incurred during the period of remodeling the Hills stores (i.e., pre-opening expenses incurred during the conversion or "dark" period) as well as certain other expenses and tax benefits.

The "Layaway Adjustment" column represents the impact of the change in the method of accounting for layaway sales. The Company adopted the change in accounting for layaway sales in the fourth quarter of Fiscal 1999 in consideration of the Staff Accounting Bulletin No. 101 "Revenue Recognition" issued by the staff of the Securities and Exchange Commission in December 1999 (see Note 1).

The following table illustrates the separate contribution to the Company's consolidated results of operations for Fiscal 1998 of (i) the operations of Ames stores during that year and (ii) the operation of the Hills stores during January 1999 and various other costs and charges discussed below.

(In millions, except per share amounts)	Fiscal 1998			
	Ames	Hills	Other Costs and Charges	Total
Net sales	$2,386.5	$112.1	$ –	$2,498.6
Leased department and other income	29.2	1.0	–	30.2
Total revenue	2,415.7	113.1	–	2,528.8
Costs and expenses:				
Cost of merchandise sold	1,711.3	66.3	–	1,777.6
Selling, general and administrative expenses	606.9	52.0	1.7	660.6
Depreciation and amortization expense, net	11.3	3.2	–	14.5
Interest and debt expense, net	11.4	2.0	1.9	15.3
Store closing charge	–	–	8.2	8.2
Income (loss) before income taxes	74.8	(10.4)	(11.8)	52.6
Income tax (provision) benefit	(26.7)	3.7	4.2	(18.8)
Net income (loss)	$ 48.1	$ (6.7)	$ (7.6)	$ 33.8
Diluted net income (loss) per common share	$ 1.99	$ (0.27)	$(0.32)	$ 1.40
Weighted average common and common equivalent shares	24.2	24.2	24.2	24.2

In January 1999, the Hills stores were being operated pursuant to the terms and conditions of the Agency Agreement (see Note 2). Approximately one-third of the Hills stores were conducting liquidation sales during January 1999 in order to prepare these stores for their conversion to Ames stores. The cost of merchandise for Hills represents the merchandise sold during January 1999 adjusted for the Guaranteed Return. The selling, general and administrative expenses for Hills include the reimbursable store operating expenses of $25.4 million; Agency Fee of $21.7 million; and other non-reimbursable expenses of $4.8 million. The depreciation and amortization expense for Hills includes the depreciation and amortization of the revalued fixed assets; the amortization of the beneficial lease rights and the goodwill recorded in the Hills Acquisition. The interest expense reflects interest on the debt, capital lease and financing obligations assumed in the Hills Acquisition.

The "Other Costs and Charges" column in the foregoing table consists of: the cost to exit certain Ames contractual obligations rendered obsolete by the Hills Acquisition; the write-off of the deferred financing costs related to the Company's 1996 credit agreement; the incremental interest expense incurred in January in connection with financing the purchase price of Hills and the charge recorded in connection with the announced closing of seven Ames stores that closed in 1999. The closings were part of planned closings resulting from the overlap in certain Ames and Hills locations.

4. Long-Term Debt

The Company's outstanding long-term debt as of January 29, 2000 and January 30, 1999 is listed and described below:

(000's omitted)	1/29/00	1/30/99
Secured Debt:		
Borrowings under the Credit Agreement	$174,544	$44,935
Unsecured Debt:		
12.5% Senior Notes, due July 2003, discount rate of 11.79%	46,295	50,875
10% Senior Notes, due April 2006	200,000	–
Total Face Value of Debt	$420,839	$95,810
Add: Premium	930	–
Amount Due After One Year	$421,769	$95,810

The Credit Agreement

On December 31, 1998, in connection with the Hills Acquisition (see Note 2), certain of the Company's subsidiaries entered into an agreement (the "Credit Agreement") with a syndicate of other banks and financial institutions for whom BankAmerica Business Credit, Inc., is serving as agent. The Credit Agreement provides for a secured revolving credit facility of up to $650 million.

The Credit Agreement replaced a $320 million secured revolving credit facility.

The Credit Agreement is in effect until the earlier of June 30, 2002 or its earlier termination pursuant to its terms and is secured by substantially all of the assets of the Company. The interest rate per annum on borrowings under the Credit Agreement is equal to the Base Rate (as defined on the Credit Agreement) plus 0% (subject to upward adjustments). Alternatively, the interest rate per annum may be equal to LIBOR Rate (as defined in the Credit Agreement) plus 1.50% (subject to upward adjustments).

Fees required under the Credit Agreement include: (a) monthly commitment fees on the unused portion of the facility; (b) an initial closing fee and (c) an initial agency fee and annual collateral management fees for the account of the agent.

For Fiscal 1999 and Fiscal 1998, the weighted average interest rate on the Company's revolving credit facilities was 8.12% and 7.57%, respectively, and the peak borrowing levels for the two fiscal years were $414.9 million and $148.3 million, respectively. As of January 29, 2000, borrowings under the Credit Agreement were $174.5 million and $2.1 million and $20.0 million was outstanding in trade and standby letters of credit, respectively.

The amount of borrowing under the Credit Agreement may not exceed the sum of (a) an amount equal to 70% of certain inventory in the possession of the Company (depending on the period of year as provided for in the Credit Agreement) plus (b) an amount equal to 50% of certain inventory not in the possession of the Company, but covered by any outstanding letter of credit. The agent, in addition, reserves the right to adjust the total available to be borrowed by establishing reserves, making determinations of eligible inventory, revising standards of eligibility or decreasing from time to time the percentages set forth above.

The financial covenant under the Credit Agreement is only in effect if Combined Availability (as defined in the Credit Agreement) falls below specified levels in any month and is limited to a minimum fixed charge coverage ratio (as defined in the Credit Agreement). As of January 29, 2000, the Company's Combined Availability was not below the specified level.

Senior Notes due 2003

The 12.5% Senior Notes due 2003 (the "Hills Senior Notes") were, at the time of the acquisition of Hills, an unsecured obligation of Hills.

The Company, in November 1998, made a tender offer to purchase at a stated discount all of the Hills' Senior Notes, which at the time totaled $195.0 million. Upon expiration of the tender offer, the Company, on December 31, 1998, paid cash of $100.8 million (including the related accrued interest) to acquire Hills Senior Notes having a face value of $144.1 million.

The tendering holders of the Senior Notes, representing 73.9% of the then outstanding Senior Notes, consented to certain modifications to the indenture governing the Senior Notes. Included among the modifications were the deletion of the sections covering reporting requirements, debt and lien incurrence and asset sales and additional subsidiary guarantees.

During Fiscal 1999, the Company, through open market purchases, acquired Hills Senior Notes having a face value of $4.6 million. In addition, during Fiscal 1999, as part of the final valuation of the fair market value of all assets and liabilities acquired in the Hills Acquisition, the Company revalued the Hills Senior Notes at a discounted rate of 11.79%. As of January 29, 2000, Hills Senior Notes with a face value of $46.3 million and a recorded value of $47.2 million remained outstanding.

Senior Notes due 2006

On April 27, 1999, the Company completed the sale of $200 million of its 10% seven-year senior notes (the "Ames Senior Notes"). The net proceeds from the sale of the Ames Senior Notes, approximately $193.4 million, were used to reduce outstanding borrowings under the Credit Agreement.

The Ames Senior Notes pay interest semi-annually in April and October and mature April 2006. Prior to April 15, 2002, the Company may redeem up to 35% of the Ames Senior Notes with the proceeds of one or more public equity offerings at a redemption price of 110% of the principal amount thereof. On or after April 15, 2003, the Company may redeem some or all of the Ames Senior Notes outstanding at a redemption price equal, initially, to 105% of the principal amount thereof. In both cases, the accrued and unpaid interest will be added to the redemption price on the applicable redemption date.

The Ames Senior Notes were issued under an indenture among Ames, its existing subsidiaries and The Chase Manhattan Bank. The financial covenants in the indenture restrict Ames' ability to: borrow money; pay dividends on or purchase Ames' stock; make investments; use assets as security in other transactions; sell certain assets or merge with other companies; and enter into transactions with affiliates. If a Change of Control (as defined in the indenture) occurs, each holder of the Ames Senior Notes has the right to require the Company to purchase all or any part of that holder's Ames Senior Notes for a payment in cash equal to 101% of the aggregate principal amount of Ames Senior Notes purchased plus accrued and unpaid interest.

As of January 29, 2000, the payments due on long-term debt for the next five years and thereafter were as follows:

Fiscal Years Ending January (000's omitted)	**Amount**
2001	$ –
2002	–
2003	174,544
2004	46,295
2005	–
Thereafter	200,000

5. Lease Commitments, Beneficial Leases and Unfavorable Lease Liability

Ames is committed under long-term leases for various retail stores, warehouses and equipment expiring at various dates through 2023 with varying renewal options and escalating rent clauses. Some leases are classified as capital leases under Statement of Financial Accounting Standards No. 13. Ames generally pays for real estate taxes, insurance, and specified maintenance costs under real property leases. Most leases also provide for contingent rentals based on percentage of sales in excess of specified amounts.

Future minimum lease payments for leases as of January 29, 2000 were as follows:

Fiscal Year Ending January	**Lease Payments**		
(000's omitted)	**Capital Leases**	**Financing Obligations**	**Operating Leases**
2001	$ 33,982	$ 8,081	$ 69,391
2002	33,305	6,434	64,820
2003	30,287	4,678	56,111
2004	27,202	5,081	49,498
2005	21,146	12,309	42,846
Thereafter	154,045	–	183,924
Total minimum lease payments	299,967	36,583	$466,590
Less: amount representing estimated executory costs	2,064	–	
Net minimum lease payments	297,903	36,583	
Less: amount representing interest	122,961	9,036	
Present value of net minimum lease payments	174,942	27,547	
Less: currently payable	16,678	5,408	
Long-term lease obligations	$158,264	$22,139	

At January 29, 2000, the financing obligations represent sale/leaseback arrangements. The leases, which have terms from 42 months to ten years, include options to purchase some or all of the assets either at the end of the initial lease term or renewal periods at an amount not greater than the then current fair market value of the properties.

Total payments have not been reduced by minimum sublease rentals to be received in the aggregate under non-cancellable subleases of operating leases of approximately $7.3 million, as of January 29, 2000. Amortization of capital lease assets was approximately $19.8, $2.8 and $0.4 million for Fiscal 1999, Fiscal 1998 and Fiscal 1997, respectively. Accumulated amortization of capital lease assets at January 29, 2000 was $23.6 million. Rent expense (income) was as follows:

(000's omitted)	**Fiscal 1999**	**Fiscal 1998**	**Fiscal 1997**
Minimum rent on operating leases	$78,946	$55,566	$48,577
Contingent rental expense	8,812	7,797	6,651
Sublease rental income	(1,423)	(1,609)	(1,730)

An unfavorable lease liability was recorded in December 1992 under fresh start reporting and represents the estimated liability related to lease commitments that exceeded market rents for similar locations. As of January 29, 2000 and January 30, 1999, the unfavorable lease liability is $11.2 million and $13.7

million, respectively, and is classified as part of other long-term liabilities in the Consolidated Balance Sheets. This liability is being amortized as a reduction to depreciation and amortization expense in the Consolidating Statements of Operations over the remaining lease terms. The amortization, recorded as a reduction to depreciation and amortization expense, was $1.4 million in each of fiscal years 1999, 1998 and 1997.

Beneficial lease rights were recorded in connection with the Hills Acquisition and represent the excess of fair market value over contract value of certain of the Hills leases. Beneficial lease rights are being amortized as part of depreciation and amortization in the Consolidated Statements of Operations over the terms of the related leases (which average approximately 25 years).

6. Stockholders' Equity

Common Stock

As provided under the Restated Certificate of Incorporation, the authorized capital stock of Ames consists of 43,000,000 shares divided into two classes: (i) 3,000,000 shares of preferred stock, par value of $.01 per share (the "Preferred Stock"), and (ii) 40,000,000 shares of common stock, par value $.01 per share (the "Common Stock").

On May 24, 1999, the Company completed the public offering of 5.1 million shares of Common Stock at a price of $38.75 per share. The proceeds, net of underwriting discounts, of approximately $187.3 million, were used to reduce borrowings under the Credit Agreement and for general corporate purposes.

There were no shares of Preferred Stock outstanding as of January 29, 2000 and January 30, 1999. There were 29,233,650 and 23,921,545 shares of Common Stock outstanding as of January 29, 2000 and January 30, 1999, respectively.

The Board of Directors of the Company may authorize the issuance of one or more series of Preferred Stock and specify for each such series the voting powers (but no greater than one vote per share), designations, preferences, and relative, participating, optional, redemption, conversion, exchange, or other special rights, qualifications, limitations, or restrictions of such series, and the number of shares in each series.

Holders of shares of Common Stock are entitled to one vote per share on all matters to be voted upon by stockholders and are entitled to receive dividends when, as and if declared by the Board of Directors. Dividends cannot be declared under the terms of the Credit Agreement.

The Common Stock does not have any preemptive right or subscription or redemption privilege. The Common Stock also does not have cumulative voting rights, which means the holder or holders of more than half of the shares voting for the election of directors can elect all the directors then being elected. All of the shares of Common Stock are fully paid and nonassessable.

Treasury Stock

In August 1998, the Company's Board of Directors approved a stock repurchase program and authorized management to purchase up to 1.5 million shares of Common Stock. During Fiscal 1998, the Company acquired 79,495 shares of its Common Stock. During the course of the third and fourth quarters of Fiscal 1998, the Company suspended further purchases due to the pending acquisition of Hills. The Company did not repurchase any of its Common Stock during Fiscal 1999.

Warrants

An aggregate of 200,000 Series B Warrants were issued on December 30, 1992. Each such warrant entitles the holder to purchase one share of Common Stock at any time from June 30, 1993 through December 30, 2000. The exercise price is $5.92 per share. During Fiscal 1998, 100,000 Series B Warrants were exercised. No Series B Warrants were exercised during Fiscal 1999.

An aggregate of 2,120,000 Series C Warrants were issued on December 30, 1992. Each such warrant entitled the holder to purchase one share of Common Stock at any time from June 30, 1993 through January 31, 1999. The exercise price was $1.11 per share. On January 31, 1999, the remaining, outstanding 8,635 Series C Warrants expired. There were no outstanding Series C Warrants at January 29, 2000.

The exercise price of the Series B Warrants are subject to adjustment upon the occurrence of certain events, including, among other things, the payment of a stock dividend, a merger or consolidation and the issuance for consideration of rights, options or warrants (other than rights to purchase Common Stock issued to shareholders generally) to acquire Common Stock.

A holder of Series B Warrants is not entitled to any rights as a stockholder of the Company, including, without limitation, the right to vote the underlying shares of Common Stock, until the holder has exercised the warrants.

Stock Purchase Rights Agreement

On November 30, 1994, the Company adopted a Stock Purchase Rights Agreement (the "Rights Agreement"). Under the terms of the Rights Agreement, one purchase right ("Right"), with an exercise price of $14.00, is attached to each share of Common Stock outstanding as of, or issued subsequent to, November 30, 1994 but prior to the occurrence of certain events (as more fully described in the Rights Agreement). The Rights become exercisable in the event that a person or group (an "Acquiring Person") either acquires 15% or more of the Company's outstanding voting stock or announces an intention to acquire 20% or more of such stock. Once exercisable, each Right will, depending on the circumstances, entitle a holder, other than an Acquiring Person, to purchase shares of either the Company or an acquiring company having a market value equal to twice the exercise price. The Rights Agreement was adopted to assure that all of the Company's stockholders receive full value for their investment in the event of stock accumulation by an Acquiring Person. Unless previously redeemed by the Company, the Rights will expire on November 29, 2004.

On September 24, 1999, the Company amended the Rights Agreement (the "Amendment"), which was approved by the Company's Board of Directors. Among other things, the Amendment amends the exercise price of a right issued pursuant to the Rights Agreement to $180.00, subject to adjustment, and makes certain other technical amendments to the Rights Agreement, most notably the elimination of certain provisions commonly known as "continuing director" provisions.

7. Stock Options

The 1998 Stock Incentive Plan (the "1998 Incentive Plan"), approved by stockholders in May 1998, provides for the grant of Awards (as defined in the 1998 Incentive Plan) and makes available for Awards an aggregate amount of 1,800,000 shares of Common Stock, with no individual awardee to receive in excess of 300,000 shares of Common Stock. With respect to such Awards under the 1998 Incentive Plan, the Company may grant awards in the form of options to purchase Common Stock provided that the exercise price shall not be less than 100% of the fair market value of the Common Stock on the date the stock option is granted.

Pursuant to the 1994 Management Stock Option Plan (the "1994 Option Plan") approved by stockholders in June 1994, the Company may grant options with respect to an aggregate of up to 1,700,000 shares of Common Stock, with no individual optionee to receive in excess of 200,000 shares of Common Stock upon exercise of options granted. The exercise prices of the options are equal to the fair market value of the Common Stock on the date the options are granted. The options become exercisable over one to five years and terminate after five to ten years from the grant date.

Pursuant to the 1994 Non-Employee Directors Stock Option Plan (the "Non-Employee Plan") approved by stockholders in May 1995, the Company may grant to non-employee directors options to purchase up to an aggregate of 200,000 shares of Common Stock. The exercise prices of the options are equal to the fair market value of the Common Stock on the date the options are granted. The options become exercisable in full six months after date of grant and terminate ten years after date of grant. Effective on the date of each annual meeting of stockholders of the Company, commencing with the 1996 Annual Meeting, each non-employee director of the Company then in office was granted an option to purchase 2,500 shares, with the date of grant to be the date of such meeting. At the 1998 Annual Meeting, the stockholders approved an amendment to the Non-Employee Plan increasing the number of options granted on the date of each Annual Meeting from 2,500 to 7,500 effective as of the May 27, 1998 grant. As of January 29, 2000, 157,500 options had been granted under the Non-Employee Plan; 137,500 options were exercisable.

The following table sets forth the stock option activity for all stock option plans for Fiscal 1999, Fiscal 1998 and Fiscal 1997 (shares in thousands):

	1999		1998		1997	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of year	1,128	$12.00	914	$3.97	1,664	$3.73
Granted	744	35.51	608	19.09	76	9.43
Exercised	(173)	6.48	(375)	3.90	(775)	4.03
Forfeited	(81)	21.46	(19)	12.42	(51)	3.59
Outstanding at end of year	1,618	22.88	1,128	12.00	914	3.97
Options exercisable at year-end	559	10.93	490	5.79	640	3.77
Weighted average fair value of options granted	$24.90		$13.56		$7.09	

The fair value of options granted per the above table was estimated on the date of grant using the Black-Scholes pricing model with the following assumptions: no dividend yield, expected option volatilities, a risk-free interest rate equal to U.S. Treasury securities with a maturity equal to the expected life of the option (weighted average interest rate of 5.3%, 5.2% and 6.4% for 1999, 1998 and 1997, respectively) and an expected life from date of grant until option expiration date (weighted average expected life of 5.3, 5.4 and 6.0 years for 1999, 1998 and 1997, respectively).

The following table summarizes information about stock options outstanding as of January 29, 2000 (options in thousands):

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Of Options Outstanding at 1/29/00	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Weighted Number Exercisable at 1/29/00	Weighted Average Exercise Price
$ 1.50-3.00	99	4.4	$2.46	99	$2.46
$ 3.13-4.38	241	1.0	3.68	241	3.68
$ 5.06-15.56	273	3.6	14.33	104	13.85
$18.38-24.75	302	3.3	22.89	77	22.27
$29.00-41.00	703	4.5	35.65	38	48.50
	1,618	3.6	22.88	559	10.93

The Company accounts for its stock option plans under APB Opinion No. 25. Had compensation cost for the Company's 1999, 1998 and 1997 stock option grants been determined in accordance with SFAS No. 123, the Company's net income and net income per common share for Fiscal 1999, Fiscal 1998 and Fiscal 1997 would have approximated the proforma amounts below:

	Fiscal 1999		Fiscal 1998		Fiscal 1997	
	As Reported	Proforma	As Reported	Proforma	As Reported	Proforma
Net income	$17,127	$10,747	$33,830	$32,065	$34,546	$34,147
Net income per common share:						
basic	$ 0.62	$ 0.39	$ 1.47	$ 1.39	$ 1.59	$ 1.57
diluted	$ 0.62	$ 0.39	$ 1.40	$ 1.32	$ 1.46	$ 1.44

SFAS 123 does not apply to stock options granted prior to 1995.

8. Income Taxes

The Company adopted SFAS No. 109 in conjunction with the adoption of fresh-start reporting in December 1992. Under SFAS No. 109, deferred income taxes are recognized by applying the enacted statutory tax rates in future years to the changes in "cumulative temporary differences" (the differences between financial statement carrying values and the tax basis of assets and liabilities).

As a consequence of the adoption of fresh-start reporting and SFAS No. 109, any tax benefits realized for tax purposes after the Consummation Date for pre-consummation cumulative temporary differences, as well as for the pre-consummation net operating loss carryovers, are reported as additions to paid-in capital (see Consolidated Statements of Changes in Stockholders' Equity) rather than as reductions in the tax provisions in the Consolidated Statements of Operations. Tax benefits or liabilities realized for book purposes after the Consummation Date will be segregated from the pre-consummation deferred tax assets. Such tax benefits or liabilities of post-consummation will impact future income tax provisions. Such income tax provisions will have no significant impact on the Company's taxes payable or cash flows.

For Fiscal 1999, the Company recorded an income tax benefit of $49.6 million. Included in that benefit is a provision for state income taxes of approximately $1.2 million, which will be paid in cash. The above tax benefit amount includes an income tax benefit of $12.7 million, related to current year operations and a benefit of $38.1 million in connection with the reduction of the valuation allowance, for post-consummation net deferred tax assets, as discussed below.

The (benefit) provision for income taxes is comprised of the following:

(In millions)	Fiscal 1999	Fiscal 1998	Fiscal 1997
Federal income tax	$ –	$ 0.5	$ 0.3
State income tax	1.2	–	–
Deferred tax (benefit) provision	(12.7)	18.3	18.8
Valuation allowance reduction	(38.1)	–	–
Total income tax (benefit) provision	$(49.6)	$18.8	$19.1

Significant components of the Company's deferred tax assets (liabilities) are as follows:

(In millions)	January 29, 2000	January 30, 1999
Fixed assets	$ 4	$ 47
Self insurance reserves	23	13
Store closing reserves	22	20
Leases	2	36
Inventory reserves	1	57
Vacation pay reserve and other	37	72
Net operating loss carryovers	327	158
Total deferred tax assets	416	403
Valuation allowances	(41)	(301)
Net deferred tax assets	$375	$102

The Company's provision for income taxes resulted in effective rates that varied from the statutory federal income tax rate as follows:

	Fiscal 1999	Fiscal 1998	Fiscal 1997
Statutory federal income tax (benefit) rate	(35.0%)	35.0%	35.0%
State and local taxes, net of federal benefit	(3.7%)	2.9%	2.8%
Goodwill amortization	2.3%	(3.4%)	(4.0%)
Other	0.4%	1.1%	1.7%
Effective tax rate before valuation allowance reduction	(36.0%)	35.6%	35.5%
Valuation allowance reduction	(122.1%)	–	–
Total effective tax (benefit) rate	(158.1%)	35.6%	35.5%

The Company has reduced its valuation allowance on its deferred tax assets by $259 million during Fiscal 1999, which reflects the Company's expectation of utilization of net operating loss carryforwards and other deferred tax assets in the foreseeable future after considering adjustments for potential contingencies. The Company has revised its policy in determining its potential to utilize net operating loss carryforwards and other deferred tax assets. The reduction of the valuation allowance resulted in a corresponding addition to paid-in-capital of $107 million, income tax benefit of $38 million and a reduction of goodwill, recorded in connection with the Hills acquisition, of $114 million.

The addition to paid-in-capital is attributable to the valuation allowance reduction on $107 million of Ames pre-consummation net operating losses and temporary differences, which were originally established by the Company as part of the adoption of fresh-start reporting in December 1992. The recognition of income tax benefit of $38.1 million is attributable to the reduction of the valuation allowance amounts previously recorded against post-consummation net operating losses and temporary differences. The remaining valuation allowance reduction of $114 million is a result of the recognition of certain deferred tax assets realized in connection with the Hills Acquisition and therefore resulted in a corresponding reduction to goodwill previously recorded. The above referenced increase to paid-in-capital was reduced by a corresponding adjustment for approximately $1.6 million relating to certain prior year state income tax liabilities.

A portion of the Ames deferred tax assets (including those created by the Hills Acquisition) continue to require a valuation

allowance because of the uncertainty of future recognition of such deferred tax assets. In subsequent periods, Ames may further reduce the valuation allowances, provided that the possibility of utilization of the deferred tax asset is more likely than not expected to occur, as defined by SFAS No. 109.

The Company has net operating loss carryovers of approximately $816 million, which are currently available without any annual limitation. These losses will expire between 2007 and 2020. Additionally, the Company has filed a $20 million refund claim under Section 172(f) of the Internal Revenue Code. The claim represents a 10-year carryback of qualified expenses and is currently under review by the Internal Revenue Service ("IRS"). The claim, if successful, will reduce net operating losses by approximately $47 million.

In addition, Ames has targeted jobs tax credit carryovers of approximately $7 million, which will expire in 2007, and alternative minimum tax credit carryovers of approximately $4 million, which have no expiration period. Federal net operating loss carryovers for fiscal years subsequent to January 27, 1990 are subject to future adjustments, if any, by the IRS.

As a result of the acquisition of the common stock of the Hills Stores Company, Ames has succeeded to the tax attributes of Hills, including net operating losses of $241 million and general business credits of $11 million. These tax attributes expire between 2000 and 2018. Ames also has succeeded to minimum tax credit carryforwards of $3 million, which do not expire. These tax attributes are significantly limited under Internal Revenue Code Sections 382 and 383, respectively, as a result of the change in control caused by the Hills Acquisition. The resulting deferred tax asset has been reduced accordingly.

Ames has substantial potential state net operating loss carryovers. The utilizable amounts of such state operating losses have not been quantified because of the uncertainty related to the mix of future profits in specific states.

The IRS has completed its audit of Hills for the 1991, 1992 and 1993 fiscal years. The final outcome of this examination did not have an adverse effect on the Company. Hills filed a claim for a refund of federal taxes for the subsequent years. The refund claim, which is pending from the IRS, could result in a refund of approximately $7.0 million. If the Company receives this refund amount, there will be a corresponding adjustment to goodwill recorded in connection with the Hills Acquisition.

9. Benefit and Compensation Plans

Retirement and Savings Plans

Ames Plan

Ames has a defined contribution retirement and savings plan (the "Ames Retirement and Savings Plan") that is qualified under Sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended, for employees who are classified as full-time and have at least 60 days of service, or who are part-time and have one year of service, and have completed at least 1,000 hours of service in a 12-month period. For each participant's contribution (up to a maximum of 5% of such participant's total compensation), the Company contributes to the Retirement and Savings Plan an amount equal to 50% of the first 4% and 100% of the next 1% contribution. Ames funds all administrative costs incurred by the plan. Ames' expense associated with this plan amounted to approximately $3.4 million, $3.3 million, and $3.0 million, in 1999, 1998 and 1997, respectively.

Hills Plan

Hills has a defined contribution retirement and savings plan (the "Hills Retirement and Savings Plan") that is qualified under Sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended, for employees who are classified as full-time and have at least 60-days of service, or who are part-time and have one year of service and have completed at least 1,000 hours of service in a 12-month period. For each participant's contribution (up to a maximum of 5% of such participant's total compensation) Ames contributes an amount equal to 50% of the first 4% and 100% of the next 1% of contribution. Ames funds all administrative costs incurred by the plan. The expenses associated with this plan were $2.6 million for Fiscal 1999 and $0.3 million for Fiscal 1998.

Retirement Plan

Ames has an unfunded Retirement Plan for Officers/Directors (the "Retirement Plan"). It provides that every person who is employed by Ames when he or she retires, dies or becomes disabled and who serves as both a full-time officer and a director of Ames and has completed five years of service, not necessarily consecutive, in both of these capacities, is eligible for benefits under the Retirement Plan.

The maximum annual benefit under the Retirement Plan is $100,000, reduced by certain of each participant's annual Social Security benefits. Each participant in the Retirement Plan is entitled to benefits for a period of 10 years. The Company has

a reserve established for potential payments under the Retirement Plan. No payments were made under this plan during the periods presented.

The G.C. Murphy Company Life Insurance Plan

The G.C. Murphy Company Life Insurance Plan (the "GCM Plan") granted a flat dollar amount (defined benefit) of group term life insurance at no cost to certain retired employees. This plan excludes G.C. Murphy Co. employees who retired from Ames after January 31, 1986. The amount of coverage varies by retiree, is payable only upon death, and has no loan or cash value. During 1997, the Company entered into a contract with an insurance company, which effectively transferred to the insurance company all future liabilities associated with the GCM Plan in exchange for fixed annual payments over ten years.

Annual Incentive Compensation Plan

The Company has an Annual Incentive Compensation Plan (the "Annual Bonus Plan") that is subject to annual review by the Board of Directors. The Annual Bonus Plan provides annual incentive cash bonuses based on the achievement of the Company's financial goals for the year (and customer service goals for store and field management). There are approximately 1,500 members of management eligible under the plan. Bonus expense recorded under the plan was $9.4 million, $8.3 million, and $6.3 million for Fiscal 1999, 1998 and 1997, respectively.

Restricted Stock Awards
1995 Long Term Incentive Plan

Pursuant to the Company's 1995 Long Term Incentive Plan (the "1995 Incentive Plan"), approved by the stockholders in May 1995, the Company may make awards of an aggregate of up to 500,000 shares of Common Stock and cash payment in an amount up to 50% of the fair market value (as defined in the 1995 Incentive Plan) of the Common Stock awarded, determined as of and paid on the vesting date. Each award under the 1995 Incentive Plan vests in full on the third anniversary of the date of grant of such award. Awards may be made to the Chief Executive Officer, any Executive Vice President and any Senior Vice President of the Company. Other than for death or disability, awards, which have not vested, are forfeited upon the termination of the employment of the executive.

As of January 29, 2000, awards aggregating to 355,000 shares of Common Stock had been made to certain executives of the Company, 35,000 of which remain unvested.

1998 Incentive Plan

Pursuant to the Company's 1998 Incentive Plan (as defined in Note 7), awards aggregating 180,000 shares of Common Stock were made to certain executives during Fiscal 1998. Awards aggregating 30,000 shares of Common Stock were made to certain executives during Fiscal 1999. Fifty percent (50%) of each stock award under the 1998 Incentive Plan vests on the fourth anniversary from the date of grant and 50% on the fifth anniversary. There is no cash payment to be made relative to the vesting of the grant.

The shares for the outstanding awards under both the 1995 Incentive Plan and the 1998 Incentive Plan have been issued and are being held in custody by the Company on behalf of the grantees thereof. A portion of the estimated market value of the awards, including the cash, has been accrued as compensation expense as of January 30, 1999. The Company recorded as compensation expense for the 1995 Incentive Plan and the 1998 Incentive Plan $1.3 million, $1.9 million, and $2.0 million during Fiscal 1999, 1998 and 1997, respectively.

Stock Appreciation Rights

In June 1998, the Company extended the employment agreement with Joseph R. Ettore, Chief Executive Officer and President. In connection therewith, Mr. Ettore was granted 125,000 stock appreciation rights (SARs) which entitle Mr. Ettore to receive in cash upon exercise the excess of (a) the average closing price of a share of Common Stock during the twenty trading days prior to the exercise date over (b) $2.00. Mr. Ettore's SARs were exercisable on or after May 31, 1999.

In August 1999, Mr. Ettore exercised 125,000 SARs. There are no remaining SARs issued or outstanding as of January 29, 2000.

Income Continuation Plan

Certain officers of Ames participate in an Income Continuation Plan ("ICP"), which guarantees up to one year's salary in the event of termination other than for cause. As of January 29, 2000, the Company had no obligations under the ICP.

Key Employee Continuity Benefit Plan

Ames has a Key Employee Continuity Benefit Plan (the "Continuity Plan") that covers all officers, Vice President and above, and certain other employees of Ames. If the employment of any participant in the Continuity Plan is terminated, other than for death, disability, Cause (as defined in the Continuity Plan) or by the participant other than for Good Reason (as defined in the

Continuity Plan), within 18 months after a change of control of Ames, the participant will receive a lump sum cash severance payment. The severance payment is 2.99 times Base Compensation for the President and Executive Vice Presidents, two times Base Compensation for Senior Vice Presidents and selected Vice Presidents and 1 times Base Compensation for other Vice Presidents. Base Compensation is defined generally as the sum of the participant's annual base compensation in effect immediately prior to the participant's termination plus one-third of the value of the cash and stock bonuses paid to the participant during the 36 months ending on the date of termination. For purposes of the Continuity Plan, a change of control includes but is not limited to the acquisition by any person of beneficial ownership of 20% or more of Ames outstanding voting securities or the failure of the individuals who constituted the Board of Directors at the beginning of any period of 12 consecutive months to continue to constitute a majority of the Board during such period.

Hills Post Retirement Benefits

Hills has a retiree medical plan that provides medical benefits to eligible retirees of Hills. This plan is accounted for in accordance with Statement of Financial Accounting Standards No. 106: "Employers' Accounting for Post Retirement Benefits Other Than Pensions" ("FAS 106"). This statement requires accrual of post retirement benefits during the years an employee provides services. Benefit costs were historically funded principally on a pay-as-you-go basis. During Fiscal 1999, the Plan was amended to restrict eligibility to employees who had attained age 61 with nine (9) years of service as of December 31, 1999. This change reduced the Company's liability for Post Retirement Benefit Costs by $2.6 million. The status of the plan is as follows:

(000's omitted)	**January 29, 2000**	**January 30, 1999**
Accumulated post retirement benefit obligation ("APBO") for:		
Active employees	$1,478	$2,293
Retirees	310	61
	1,788	2,354
Plan assets at fair value	–	–
Unfunded APBO	1,788	2,354
Unrecognized actuarial gain	–	1,442
Accrued post retirement benefit cost	$1,788	$3,796

The assumed health care cost trend rate used in measuring the APBO was 7% in fiscal year 1999 grading down to 5% by fiscal year 2002 and remaining at that level thereafter. A one percentage point increase in the assumed health care cost trend rate would increase the APBO at the end of fiscal year 1999 by $52,300 (or by 3%) and the service and interest cost by $35,200 (or by 11%). Conversely, a one percentage point decrease in the assumed health care cost trend rate would decrease the APBO at the end of the fiscal year 1999 by $50,700 (or by 3%) and the service and interest cost by $28,800 (or by 9%). The assumed discount rate used in determining the APBO was 7%.

10. Commitments and Contingencies

Wage and Hour Litigation

Since March 1995, the Company has been named as a defendant in several class action complaints, which allege that the Company was obligated to pay overtime to its hardlines and softlines assistant store managers. The Company has consistently stated its belief that these positions are appropriately designated as exempt positions not calling for overtime pay. The Company has settled several of these cases. These settlements have not required any change in the Company's treatment of the status of its hardlines and softlines assistant managers. The Company is vigorously defending one remaining case, which it does not believe represents a material exposure.

Other Matters

In June 1999, the Company announced a $112 million, five-year, strategic outsourcing agreement with IBM to support core information technology systems for the corporate office and the stores. Under the agreement, IBM Global Services is responsible for all data center operations, which includes mainframe, midrange and client server systems; support for midrange systems in Ames' four distribution centers; and support for substantially all information systems equipment in all of the Ames stores. The Company expects that this agreement will cost less in service delivery than if it had not outsourced its information technology support.

The Company is party to various claims and legal proceedings covering a wide range of matters that arise in the ordinary course of its business. The Company believes that its likely liability as to these matters will not have a material adverse effect on its consolidated financial position or results of operations.

11. Supplemental Cash Flow Information

Fiscal (000's omitted)	Fiscal 1999	Fiscal 1998	199
Cash paid for interest and income taxes was as follows:			
Interest	$51,485	$12,166	$11,655
Income taxes	3,646	125	73
Ames entered into other non-cash investing and financing activities as follows:			
New capital lease obligations	$14,942	$25,859	$ 2,940
Issuance of Common Stock under the 1998 Incentive Plan	–	2	–

Inventory increased $28.3 million in Fiscal 1999 when a purchase accounting valuation adjustment related to the Hills Acquisition was deemed to be no longer necessary and was eliminated, resulting in a corresponding reduction of goodwill. This increase in inventory is properly not reflected as a use of cash in the Consolidated Statement of Cash Flows.

12. Fair Values of Financial Instruments

The Financial Accounting Standards Board requires disclosure of the fair value of financial instruments under Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments." The following methods and assumptions were used by the Company in estimating the fair value disclosures for its financial instruments.

The Company's financial instruments as of January 29, 2000 and January 30, 1999 were cash and short-term investments, and long-term debt. For cash and short-term investments, the carrying amounts reported in the Consolidated Balance Sheets approximated fair values. For long-term debt obligations, the fair values were estimated using a discounted cash flow analysis (based upon the Company's incremental borrowing rates for similar types of borrowing arrangements).

The carrying amounts and fair values of the Company's financial instruments at January 29, 2000 and January 30, 1999 were as follows:

	Fiscal 1999		Fiscal 1998	
(000's omitted)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and short-term investments	$30,612	$30,612	$35,744	$35,744
Long-term debt:				
Secured debt	174,544	174,544	44,935	44,935
Unsecured debt	247,225	236,758	50,875	50,875

13. Store Closing Charges

The Company did not record any charges in connection with the closing of stores during Fiscal 1999. The Company spent approximately $9.5 million, $2.5 million and $13.9 million in Fiscal 1999, 1998 and 1997, respectively, related to store closing costs.

In the fourth quarter of 1998, the Company recorded charges of $8.2 million in connection with the closing of seven stores that overlap markets with acquired Hills stores. The seven stores were closed during Fiscal 1999.

In the fourth quarter of 1997, the Company recorded charges of $1.6 million in connection with the closing of two stores. The $1.6 million is classified in two line items: $1.0 million as store closing charge and $0.6 million as part of cost of merchandise sold.

The following items represent the major components of the total charges recorded in January 1999 and 1998 in connection with store closings:

Item (000's omitted)	Fiscal 1999	Fiscal 1998	Fiscal 1997
Lease costs	$–	$6,254	$ 363
Net fixed asset write-down	–	1,161	394
Severance costs	–	370	113
Other	–	437	130
Store closing charge	–	8,222	1,000
Inventory write-down	–	–	560
Total charges	$–	$8,222	$1,560

The lease costs provided for in the store closing charge include all projected occupancy costs from date of closing until estimated lease disposition date.

The remaining closed store reserve recorded at the end of Fiscal 1999 primarily reflects the anticipated costs of ongoing property lease commitments for previously announced closed stores and other related facility exit costs.

14. Leased Department and Other Income

The following is a summary of the major components of the "Leased department and other income":

Item (In thousands)	Fiscal 1999	Fiscal 1998	Fiscal 1997
Leased department income	$25,378	$17,914	$16,592
Concession and vending income	1,991	1,508	1,252
Layaway service fees	3,736	2,644	2,605
Gain on sale of assets, net	2,479	1,350	1,084
Various other	8,106	6,748	3,536
	$41,690	$30,164	$25,069

15. Recently Issued Accounting Pronouncements

In June 1998 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. The Statement also requires that changes in derivatives fair value be recognized currently in earnings unless specific hedge accounting criteria are met. SFAS No. 133 is effective, prospectively, for all fiscal quarters of all fiscal years beginning after June 15, 2000, with early adoption at the beginning of any fiscal quarter being permitted. Management is currently analyzing the impact of this new pronouncement on the Company's financial position and results of operations.

16. Quarterly Financial Data (Unaudited)

Summarized unaudited quarterly financial data for the last three fiscal years are shown below.

	First	Second	Third	Fourth
	(In thousands, except per share data)			
Fiscal 1999: (a)				
Net sales	$ 816,159	$ 859,975	$ 883,500	$1,277,220
Gross margin	238,586	258,953	245,045	378,884
Income (loss) before cumulative effect adjustment	(28,639)	(21,478)	(27,700)	96,051
Income (loss) per diluted share before cumulative effect adjustment	(1.19)	(0.78)	(0.95)	3.23
Net income (loss)	(29,746)	(21,478)	(27,700)	96,051
Net income (loss) per share:				
basic	(1.23)	(0.78)	(0.95)	3.30
diluted	(1.23)	(0.78)	(0.95)	3.23
Fiscal 1998:				
Net sales	$497,045(b)	$535,047(b)	$596,030(b)	$870,526(b)
Gross margin	138,434	156,836	163,094	262,623
Net income (loss)	(2,943)	8,386	6,000	22,387
Net income (loss) per share:				
basic	(0.13)	0.37	0.26	0.96
diluted	(0.13)	0.35	0.25	0.92
Fiscal 1997:				
Net sales	$430,629(b)	$502,414(b)	$524,864(b)	$767,549(b)
Gross margin	118,984	146,863	148,081	215,554
Net income (loss)	(5,930)	7,378	3,519	29,579
Net income (loss) per share:				
basic	(0.28)	0.34	0.16	1.32
diluted	(0.28)	0.31	0.15	1.23

(a) First three quarters restated to reflect the adoption of SAB 101 as of the beginning of Fiscal 1999 (see Note 1).

(b) Restated to reflect the effect of recording promotional coupons issued by Ames as markdowns, which conforms to current treatment for coupon accounting.

17. Pro Forma Information (Unaudited)

The following table reflects unaudited pro forma combined results of operations of the Company and Hills on the basis that the Hills Acquisition had taken place at the beginning of each of the fiscal years presented:

(In thousands, except per share amounts)	Year Ended January 30, 1999	Year Ended January 31, 1998
Net sales	$4,131,194	$4,001,392
Net income (loss)	(54,903)	27,635
Earnings (loss) per common share	$ (2.39)	$ 1.27

These unaudited pro forma results have been prepared for comparative purposes only. They do not purport to be indicative of the results of operations which actually would have resulted had the acquisition been consummated at the beginning of Fiscal 1997 or Fiscal 1998, or of future results of operations of the consolidated entities.

The above pro forma net income and earnings per common share amounts for the year ended January 30, 1999 reflect the previously recorded write-down of Hills deferred tax assets of approximately $49.6 million (which is net of a reversal of approximately $5.9 million of accrued tax liabilities). Excluding the write-down of the Hills deferred tax assets recorded as of October 31, 1998, pro forma net loss and loss per common share would have been $5.3 million and $0.23, respectively, for the year ended January 30, 1999.

18. Subsequent Events

In February 2000 the Company entered into an agreement with Goldblatt's Department Stores, Inc. to purchase the leases to six of their stores in Chicago, Illinois and one store in Gary, Indiana for a cash purchase price of $7.6 million. The purchase was completed in April 2000. Under the terms of the agreement, the Company assumed Goldblatt's leases for the seven stores. Goldblatt's delivered the stores to the Company in "broom clean" condition.

Selected Company Data

Market for the Company's Common Stock

The following table provides the high and low last sale prices for our common stock as reported on NASDAQ for the fiscal quarterly periods indicated below. These prices do not include retail markups, markdowns or commissions.

	Fiscal 1999		Fiscal 1998	
	Low	**High**	**Low**	**High**
1st Quarter	$25 3/8	$38 3/4	$14	$25 1/2
2nd Quarter	34 13/16	48 7/8	21 1/8	29 5/8
3rd Quarter	27 5/8	42	10 1/2	25 3/8
4th Quarter	20 3/4	34 11/12	18 1/8	32 1/2

On March 31, 2000, there were approximately 6,200 holders of record of the common stock. On that date, the reported sale price of our common stock was $24.56.

We paid no quarterly dividends to the holders of our common stock during these periods. Dividends cannot be declared under the terms of our bank credit facility. Any future determination to pay cash dividends will be at the discretion of the Board of Directors and will be dependent upon our financial condition, operating results, capital requirements and such other factors as the Board of Directors deems relevant.

On September 24, 1999, we adopted Amendment No. 1 to the Rights Agreement dated as November 30, 1994 as described in Note 6 to the Consolidated Financial Statements.

Disclosure About Market Risk

We have exposure to interest rate volatility primarily relating to interest rate changes applicable to revolving loans under our bank credit facility. These loans bear interest at rates which vary with changes in (i) the London Interbank Offered Rate (LIBOR) or (ii) a rate of interest announced publicly by Bank of America NT&SA.

We do not speculate on the future direction of interest rates. As of the end of fiscal years 1999 and 1998 our exposure to changing market rates was as follows:

	January 29, 2000	**January 30, 1999**
Variable rate long term debt ($US)	$174.5 million	$44.9 million
Average interest rate	8.31%	8.38%

Selected Financial Data

The following selected financial data of Ames should be read in conjunction with the Consolidated Financial Statements and related Notes appearing elsewhere in this Annual Report.

(In millions, except per share data)	**Fiscal Year Ended Jan. 29, 2000**	**Fiscal Year Ended Jan. 30, 1999 (b)**	**Fiscal Year Ended Jan. 31, 1998 (c)**	**Fiscal Year Ended Jan. 25, 1997**	**Fiscal Year Ended Jan. 27, 1996**
Net sales	$3,836.9(a)	$2,498.6(j)	$2,225.5(j)	$2,155.3(j)	$2, 088.5(j)
Net income (loss)	17.1(i)	33.8(g)	34.5(d)	17.3(e)	(1.6)(f)
Net income (loss) per common diluted share (h)	0.62(i)	1.40	1.46(d)	0.79(e)	(0.08)(f)
Total assets	1,975.3	1,483.4	610.0	536.8	502.6
Long-term debt and capital leases	602.2	287.7	35.7	38.2	52.5

(a) Net sales reflects change in accounting for layaway sales pursuant to SAB 101.

(b) Includes Hills Stores Company financial results for January 1999.

(c) Fiscal year ended January 31, 1998 consisted of 53 weeks; all other years presented consisted of 52 weeks.

(d) Includes charges of $1.6 million for the costs associated with the closing of two (2) stores.

(e) Includes charges of $9.7 million for the costs associated with the closing of thirteen (13) stores and an extraordinary loss, net of tax, of $1.4 million for the early extinguishment of debt.

(f) Includes charges of $20.9 million for the costs associated with the closing of seventeen (17) stores and property gains of $9.1 million.

(g) Includes $8.2 million for the costs associated with the closing of seven stores.

(h) Net income (loss) per common share has been restated to conform to the requirements of Statement of Financial Accounting Standards No. 128 "Earnings per Share" ("SFAS No. 128"). See Note 1 to the Consolidated Financial Statements for a further description of the provisions of SFAS No. 128.

(i) Includes cumulative effect adjustment for change in accounting for layaway sales of $1.1 million, net of $0.6 million tax benefit, and the recognition of approximately $38 million in tax benefits (see Note 8).

(j) Includes adjustment to sales to reflect the effect of recording promotional coupons issued by Ames as markdowns, which conforms to the current treatment for coupon accounting.

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